HARVARD Kennedy School
ASH CENTER
for Democratic Governance
and Innovation

FROM REFORMASI TO INSTITUTIONAL TRANSFORMATION

A Strategic Assessment of Indonesia's Prospects for Growth, Equity and Democratic Governance

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Preface by Peter Sondakh

Leadership with a full heart

Based on my 35 years of experience in business, I see that successful leaders lead from the heart, whether they be a janitor, a manager, or even a director. The most simple measurement of success is not how many people serve us, but rather how many of the people we serve actually feel a benefit of our leadership.

We often hear the mantra that Indonesia is rich in natural resources. With this natural wealth, automatically we expect that all the people of Indonesia will have a decent standard of living. But this way of thinking raises a few concerns. One, as is described in more detail in this book, the amount of natural resources in Indonesia is decreasing over time. Much of the original natural wealth has been wasted or thrown away and we can't get it back. Two, we have seen that these natural resources have not translated into benefits for the majority of the population, and that only small groups of our society benefit.

One of the proofs of this phenomenon is the significant level of poverty in Indonesia. According to March 2009 survey data from the Indonesian Central Statistics Bureau (BPS), there were 32.5 million "poor" Indonesians, which is 14.15% of the total population. This strategic assessment report finds that the reported poverty level far under-reports the actual poverty. One reason is that Indonesia uses one of the lowest definitions of official poverty in Asia, but another reason is that the official poverty definition is itself below the minimum standard of living that the government also recognizes. If we wanted to be more honest in looking at this situation, the level of poverty is far greater than has been officially reported by BPS.

Even though BPS data has shown that poverty decreased slightly from 2008 to 2009, we still need to ask why there are still so many poor Indonesian families. Are our government policies not adequately pro-poor? Or is it a problem of our human resources? And in terms of leadership, are our national leaders truly leading with a full heart?

The people of Indonesia have actually already taken great steps to correct the leadership of the country, which previously had been seen as not adequately ensuring the welfare of all Indonesians. Twelve years ago, a reform movement of the people swept in changes in the constellation of our main political leaders. Even after a decade of this political reform, however, the new leaders have not been able to solve the multi-dimensional problems we face.

Recognizing that these conditions are further challenged by globalization, the Rajawali Foundation supported the Harvard University Kennedy School of Government on a strategic assessment report in early 2010 about the social and economic reality of Indonesia and the challenges going forward. Because of the interest in the report, it was also translated into the Indonesian language and published in 2010 under the title *Indonesia Menentukan Nasib*. We hope that the English and Indonesian versions of this report—which are based on the work of researchers from the Harvard Kennedy School of Government and also researchers from Indonesia—will add to the dialogue about how to bring Indonesia to a better future.

I hope this book will help Indonesia greet the 21st century. And more importantly, will help us understand the steps of institutional transformation that we need to take in order for our country's leadership to be better able to lead with a full heart.

Sincerely,
Peter Sondakh
Chairman, Rajawali Foundation
Jakarta, Indonesia

Preface by Anthony Saich

This book represents a first attempt to understand the progress and the challenges that face Indonesia as it enters its second decade as a democratic nation. Progress has been significant and the government has made impressive gains over the past decade. Indonesia has emerged as the world's first majority Muslim, multi-party democracy, which is not an easy achievement. It has held together after the turmoil that followed the end of the Suharto years. There has been steady economic growth and the country has come through the global financial crisis better than many other countries. The formal structures of the New Order regime have been dismantled, civilian rule has been enshrined, peace has been brought to Aceh and most civil liberties have been restored.

Despite this impressive progress, we highlight a number of problems that are preventing Indonesia from achieving its full potential. In comparison with a number of its neighbors, Indonesia is falling behind in crucial economic and social measures with the result that the economy needs to grow more quickly while the fruits of growth need to be distributed more equitably. A number of the barriers to more effective growth result from the incomplete institutional transformation from the periods of "Guided Democracy" and the "New Order". Remaining challenges include high barriers to entry in a wide range of industries, a dysfunctional legal system, the continuation of patrimonial politics, and insufficient investment in infrastructure, health and education.

The completion of these reforms is all the more urgent as a consequence of the global business revolution and the emergence of China as a focal point in the global production chain. Moving beyond the institutional legacies of the past will mark a start. In addition, Indonesia must learn to be less inward looking and accept international performance standards so that full advantage can be taken of what globalization has to offer. This process will be aided by government, law and the business and finance sectors shifting from protecting insiders to enforcing accountability and stimulating innovation. To put the economy and society on a sound footing, it is necessary to build up the "missing middle"—a thriving private sector in the economy and a lively middle class of politically engaged consumers.

This project marks a first attempt to understand the challenges that Indonesia is confronting and we welcome engagement with our colleagues in a wide ranging discussion. The report was written by an interdisciplinary team from the Ash Center for Democratic Governance and Innovation at the Harvard Kennedy School and it benefitted from the input and advice from numerous Indonesian colleagues.

Moving forward with the generous support of the Rajawali Foundation, our Indonesia Program at the Ash Center of the Harvard Kennedy School hopes to bring students and scholars to Harvard, while also sending students and faculty to Indonesia. Further, we hope to develop a number of executive training programs that will help enhance the public policy skills of Indonesian officials. Last but not least we hope to launch a number of collaborative research projects that will address in more detail the problems identified in the report. We hope that these activities will make a small contribution to enabling Indonesia to make the kind of progress that it surely deserves.

Anthony J. Saich
Director, Ash Center for Democratic Governance and Innovation,
and
Director, Rajawali Foundation Institute for Asia

Harvard Kennedy School
Harvard University
Cambridge, Massachusetts, United States

Executive Summary

The Harvard Kennedy School Indonesia Program was inaugurated in January 2010. The first activity of the new program was to carry out a strategic assessment of Indonesia's prospects for economic growth and democratic governance. Inspired by a similar exercise completed in Vietnam in 2008, the objective of the strategic assessment was to identify key research themes and stimulate critical discussion of the country's development challenges. This book reports the findings of the assessment.

The *reformasi* era has inherited a legacy of economic oligarchy and "collusive democracy" from the New Order and Guided Democracy periods. Economic oligarchy and political collusion are maintained through high barriers to entry in a wide range of industries, a dysfunctional legal system, patrimonial politics, disempowered citizens and an attenuated sense of national citizenship. Oligarchy and collusive democracy have left Indonesia ill-equipped to respond to the challenge of globalization. Like a marathoner carrying a twenty kilogram pack, Indonesia can see the competition pulling away but is powerless to pick up the pace. Although there are few remaining controls on Indonesian media and universities, it is difficult to find much in the way of serious discussion of these issues in the press and in scholarly journals.

This book argues that Indonesia must engage in a thorough process of institutional transformation if it is to shed the legacy of Guided Democracy and the New Order and learn to compete in the new globalized economy. Indonesian firms must be more nimble, linked more closely to the international economy and less dependent on government protection. Barriers to the formation of new firms must be eliminated, since it is likely that the world beaters of the future will not be drawn from the legacy firms carried over from the past. Barriers to job growth and formalization of small businesses must also be relaxed to help working people reduce the risk of falling into poverty and to increase opportunities for upward mobility. The legal system—courts, prosecutors, police, lawyers—must uphold the law and the rights of citizens without bias. Building a more competitive economy requires the creation of more responsive and open political system that is geared less to gate-keeping and protecting privilege and more to a reconstructive democratic citizenship.

We began this book with a discussion of the impact of the globalization of production and trade systems over the past two decades. Digitization, lower transport and communication costs, advances in production technology and falling trade barriers have revolutionized global manufacturing, which is increasingly divided up into discrete steps carried out in numerous and often far-flung locations. Vertical integration no longer takes place in one place or even in one firm, but instead is led by large multinational system integrators that coordinate activities of hundreds of lower tier suppliers. Boundaries between firms have become blurred as system integrators take greater direct control over their suppliers' production processes and demand constant improvements in efficiency and quality. Costs are compressed through intensified competition at every stage of production, which makes it more difficult for new firms to gain a foothold. However, modularization does create new opportunities for developing countries to insert themselves into global supply chains, as system integrators are willing to share technology and support capacity development of new suppliers. Encouraging foreign direct investment in strategic industries is the most reliable means of linking into these supply chains.

China's phenomenal economic growth also presents challenges and opportunities to countries in the region. China has emerged as the world's assembler, importing components from the rest of Asia and exporting final products to western markets. Indonesia currently runs a trade deficit with China, exporting raw materials and importing manufactured goods. Although pressure is rising from domestic producers to protect Indonesian markets from Chinese imports, this kind of defensive response is likely to harm Indonesia in the long run. Indonesian companies must learn how to compete with China in some products and integrate into China-based supply chains in others. Retreating behind tariff barriers is not a viable strategy.

Although Indonesia has posted respectable growth rates during the recent global crisis, from a longer term perspective the country is becoming less competitive. Indonesia is changing, but most of the dynamic economies of East Asia are changing faster. Indonesia is losing ground to China, India, Thailand, Malaysia, Vietnam and the Philippines in foreign direct investment flows, manufacturing, infrastructure and education. Indonesia's social indicators are also lagging behind other middle income countries.

Domestic consumption and high commodity prices are not adequate foundations on which Indonesia can build an upper middle income economy. Indonesia gets low marks for technological readiness, infrastructure, health and primary education, higher education and training and labor market efficiency. Growth in manufactured exports has been slow in comparison with neighboring countries. Indonesia has not succeeded in linking into Chinese supply chains like Thailand, Malaysia and the Philippines. Indonesia's most dynamic export is palm oil, which reflects the economy's over-reliance on natural resources. Competitiveness is also held back by an overvalued exchange rate that encourages imports and pleases bond holders but penalizes exporters.

Foreign direct investment in Indonesia is concentrated in natural resource exploitation and the production of consumer goods for the domestic market. Indonesia's involvement in the production of information technology and telecommunications components is still limited. Foreign investors are put off by the poor quality of the country's infrastructure, notably roads, ports and power. Per capita availability of power in Indonesia is lower than in Vietnam. The problem of power supply will not be solved until subsidies are reduced, because at the moment increasing the supply of electricity imposes a massive cost burden on government. The government must strike a deal with the public to raise the cost of power in exchange for a more reliable service, and to use the money now spent on subsidies to expand capacity, build roads and improve access to education and health.

Lack of competitiveness and overly restrictive labor regulations have slowed the rate of job creation. Access to stable wage employment is the surest path out of poverty for most Indonesians, yet the country has suffered a form of "jobless growth" during the *reformasi* period. Indonesia's social indicators are also falling behind neighboring countries. An Indonesian child is now nearly three times as likely to die before his or her fifth birthday as a Vietnamese child. Progress in providing access to clean water and sanitation has been slow. Nearly one third of children suffer from moderate to severe stunting, and nearly one fifth are underweight. Mothers in Indonesia are more than three times more likely to die in childbirth than Vietnamese mothers. These basic indicators of well-being are the most direct measure of government effectiveness. Reducing child and maternal death requires the creation and maintenance of basic public health care systems that are capable of delivering quality services to even the poorest households. Successive *reformasi* governments have failed to achieve this modest objective.

Nevertheless, Indonesia is often seen as a "pro-poor growth" success story. Measured poverty fell sharply from 1970 to 1996 while inequality did not change much. However, the reliability of these statistics is open to question. Consumption surveys systematically undercount the rich, and the problem appears to be growing worse over time. Indonesia's official poverty line is one of the lowest in the region. Increasing the poverty line by one-fourth would result in a jump in poverty from 18 to 53 percent of households.

What does Indonesia need to do to improve economic performance and lift more of its citizens out of poverty? One of the main messages of the book is that the government does too many unproductive things and fails to act when it should. The country has squandered its natural heritage by allowing destruction of its forests to continue unchecked. At the same time, Indonesia has underinvested in health and education. Indonesia is one of the few countries in the world that exports more raw ores than metals. The government over-regulates the economy, operating a "license *kerajaan*" analogous to the License Raj of pre-reform India. Over-regulation protects incumbent large firms and penalizes start-ups and small companies. It also forces millions of small and medium scale companies into the informal sector. The resulting industrial structure is dominated by a few huge companies resting on top of a sea of micro-enterprises. The "missing middle" phenomenon is a symptom of weak legal and regulatory institutions. Inadequate protection of property rights and corrupt courts leave small businesses vulnerable to predators with money and political connections. Many of Indonesia's state-owned enterprises are a drag on the economy. The Financial Services Authority has not yet developed the technical capacity and political autonomy needed to conduct independent bank regulation and supervision.

Improving the quality of Indonesian government institutions will not be easy. Democracy has not eliminated corruption or strengthened the rule of law. The economic oligarchy survived the financial crisis largely intact, and its relationship to the state is unchanged. The institutional legacy of the Guided Democracy and New Order periods continues to weigh heavily on the country's economy, society and politics. Even social scientists have not yet been able to shake off habits developed over forty years of authoritarian rule. Despite the greater academic freedom of the *reformasi* period, few scholars have shown an interest in attempting a critical reassessment of the Guided Democracy and New Order periods. Nor has there been a noticeable increase in quantity or improvement in quality of empirical social science research.

We emphasize five aspects of the institutional legacy of the Guided Democracy and New Order periods: military versus civilian rule; integration versus decentralization; the "floating mass" versus democratic participation; rule by law versus rule of law; and patrimonialism versus institutional development. Indonesia must arrive at a fuller understanding of these legacies before the country can begin to reform its public institutions. Another essential element of reform is the reconstruction of Indonesian citizenship, by which we mean a renegotiation of the relationship between citizens and the state. The state must be transformed from a vehicle that provides favors and facilities to the rich and powerful, into a "rule of law" state that works to realize the rights of all citizens regardless of income, region, gender, ethnicity or religion.

Institutional transformation is a long term project. The book concludes with a brief discussion of several measures to help propel the process forward. These include electoral reform, imposing international standards on some economic institutions, improving the implementation of political and administrative decentralization policy and giving more Indonesians a stake in stability and democracy. The conclusion proposes several broad categories of further research, including work on the opportunities and challenges of globalization, a reinvestigation of poverty and inequality, and the potential for national citizenship in Indonesia.

Introduction

Ten years ago, a time still fresh in our memory, our country experienced a terrible crisis… 1999 was a year full of problems and challenges. Many people at home and overseas were concerned about the future of our country, and even our survival as a nation.

At that time there were at least five possible scenarios for our country. The first predicted that Indonesia would balkanize or split into many small countries because of rising regionalist sentiment. The second scenario saw Indonesia become a hardline Islamic country because of the appearance of religious sentiments seeking to marginalize the ideology of Pancasila. The third scenario predicted that Indonesia would become a semi-authoritarian country without clear direction. The fourth scenario saw Indonesia moving backwards to authoritarianism. Few people predicted that Indonesia would take the fifth road, namely not just a democratic country, but a stable and united democratic country.

President Susilo Bambang Yudhoyono, August 14, 2009

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In ruins just a decade ago, Indonesia's economy these days seems a remarkably sturdy structure. Having been worse hit than any other by the Asian economic crisis of 1997-98, it has, by some measures, weathered the global slump of 2008-2009 surprisingly well. Economic growth has slowed by less than in most other big countries. In part that is a gauge of its underachievement compared with faster-growing China and India…. But given Indonesia's starting point a decade ago, that is still impressive.

The Economist, September 10, 2009

The Harvard Kennedy School Indonesia Program was inaugurated in January 2010. The first activity of the new program was to carry out a strategic assessment of Indonesia's prospects for economic growth and democratic governance. Inspired by a similar exercise completed in Vietnam in 2008, the objective of the strategic assessment was to identify key research themes and stimulate critical discussion of the country's development challenges.[1] This book reports the findings of the Indonesia strategic assessment.[2]

The central issue in Indonesia's political economy, and this book, can be stated as follows: the *reformasi* era has inherited a legacy of economic oligarchy and "collusive democracy" from the Guided Democracy (1957-1965) and New Order (1966-1998) periods.[3] Economic oligarchy and political collusion are maintained through high barriers to entry in a wide range of industries, a dysfunctional legal system, patrimonial politics and an attenuated sense of national citizenship. Even in normal times this legacy would be a major obstacle to economic

[1]The main report of the Vietnam strategic assessment is "Choosing Success: The Lessons of East and Southeast Asia and Vietnam's Future," Vietnam Program, Ash Center for Democratic Governance and Innovation, Harvard Kennedy School, January 2008, available in English at http:www.innovations.harvard.edu/showdoc.html?id=98251 and has also been published in several forms English and Vietnamese.

[2]This strategic assessment was carried out by a team led by Anthony Saich and consisting of Jonathan Pincus, David Dapice, Tarek Masoud, Dwight Perkins, Jay Rosengard, Thomas Vallely, Ben Wilkinson and Jeffrey Williams. Jonathan Pincus took the lead in integrating the various components of the report into a coherent whole. The ideas expressed in this book are those of the authors alone and do not necessarily reflect the views of the Rajawali Foundation or the Harvard Kennedy School. The authors take full responsibility for the information contained in this book and for any errors of fact or interpretation. The authors wish to thank the following people who have provided substantive comments and suggestions during the strategic assessment and the drafting of this book: Arif Arryman, Michael Buehler, Chaikal Nuryakin, Eko Prasodjo, Y.W. Junardy, Kiki Verico, Padang Wicaksono, A. Prasetyantoko, Robertus Robet, Fritz Simandjuntak, Benny Subianto, Surjadi, Uswatun Hasanah and Jeffrey Winters. Elizabeth Osborn assisted with editing the printed book version. The authors would also like to thank the scholars, business leaders, politicians and government officials—too many to list here—who took the time to meet and share their views and analyses of specific issues.

[3]The term "collusive democracy" is Dan Slater's (2004). On Indonesia's economic oligarchy see Winters 2010.

growth and democratic change. But these are not normal times. The world is experiencing an exceptional period of economic upheaval. Globalization has transformed production systems, the organization of business enterprises, relationships between firms and economic relations between industrial and developing economies. Indonesia, hamstrung by oligarchy and collusive democracy, is ill equipped to respond to the challenge of globalization. Like a marathoner carrying a twenty kilogram pack, Indonesia can see the competition pulling away but is powerless to pick up the pace.

This book argues that Indonesia must engage in a thorough process of institutional transformation if it is to shed the legacies of the Guided Democracy and the New Order and learn to compete in the new globalized economy. Indonesian firms must be more nimble, linked more closely to international production systems and less dependent on government protection. Barriers to the formation of new firms must be eliminated, since it is likely that many of the Indonesian world beaters of tomorrow will be new enterprises rather than firms carried over from the New Order. Barriers to job growth and formalization of small businesses must be relaxed to help Indonesian families reduce the risk of falling into poverty and to increase opportunities for social mobility. The legal system—courts, prosecutors, police, lawyers—must uphold the law and the rights of citizens without bias. Building a more competitive economy requires the creation of a more responsive and open political system that is geared less to gate-keeping and protecting "insiders" and more to a reconstructed democratic citizenship.

These conclusions may appear startling to those—both in Indonesia and abroad—who have grown accustomed to reading glowing reports of Indonesia's progress from the brink of national disintegration during the East Asia financial crisis to its current status as the newest member of the "BRIC" group of emerging economies.[4] Our

[4]BRIC is an acronym coined by the investment bank Goldman Sachs to refer to Brazil, Russia, India, and China, which are large emerging economies that taken together now account for fifteen percent of global output. The group held their first summit meeting on June 16, 2009. Numerous commentators have speculated on the place of Indonesia in this group. See, for example, Ghosh 2009.

intention is not to minimize the importance of the achievements of the past decade. Indonesia has indeed made tremendous progress during the *reformasi* era. Much of the formal institutional apparatus of the New Order has been dismantled. Governed for more than three decades by a military-backed, highly centralized authoritarian regime, Indonesians now enjoy one of the most open and democratic political systems in the region. The military has surrendered its claim to a formal political role, parliament has asserted its independence from the executive, political parties organize freely, leaders at the national and local level are selected through competitive elections and civil liberties have been restored. Peace has been achieved in Aceh after 29 years of conflict. Resources and decision-making power have been decentralized to local government. Indonesia has demonstrated to the world—and, perhaps more importantly, to itself—that democracy is compatible with stability and economic progress even in a large, ethnically and religiously diverse country.

The gains of the last ten years are all the more remarkable when we recall the total collapse of the nation's economic and political institutions in the wake of the 1997/98 financial crisis. By mid-1998 Indonesia's financial system lay in ruins and the corporate sector was essentially bankrupt. The official poverty rate tripled but even this shocking statistic does not capture the extent of the economic hardship faced by millions of lower income urban and rural households. Price inflation exceeded 80 percent but food prices rose twice as fast. Economic collapse bred social dislocation, violence and a sharp rise in criminality. The country was gripped by mass paranoia, anxiety and depression (Friedman and Thomas 2007). A surge in ethnic and religious intolerance sparked localized violence and a wave of regionalism. The army's vengeful outburst in East Timor further undermined the legitimacy of the central state and damaged Indonesia's standing in the world. As President Susilo Bambang Yudhoyono remarked in his 2009 State Speech, there was some doubt in 1999 as to whether Indonesia would even survive as a unified nation.

Indonesia survived. After a few false starts, a case can now be made that the country is heading for a new period of rapid growth and rising living standards. Although gross domestic product (GDP) per capita did not regain its pre-crisis level until 2005, three years later income per person was already twenty percent above 1997 levels. Growth in 2009 was 4.4 percent despite a global financial crisis and a sharp drop in commodity prices. Public debt has fallen from 80 to 33 percent of GDP. Indonesia stands to benefit from growing demand for agricultural commodities and minerals, much of which emanates from China.

The re-election of President Yudhoyono in the first round of voting in July 2009 was widely viewed as a sign of the coming of age of Indonesia's democracy and an opportunity for the government to intensify its reform efforts. Reflecting investors' optimism in the wake of the elections, Standard and Poor's upgraded its outlook on Indonesia's sovereign debt rating from stable to positive. Although the attacks on the Marriot and Ritz Carlton hotels in July 2009 momentarily raised fears about security and political stability, confidence was quickly restored.

Even the most optimistic observers recognize that Indonesia must still overcome a number of serious economic problems. Basic infrastructure is underprovided and the government's efforts to step up the pace of construction have stalled. Bureaucratic obstruction and red tape stifle initiative and reduce competition in the marketplace. Corruption impairs the government's capacity to provide public goods and to act as an impartial regulator. Opinion surveys report that nearly two-thirds of Indonesians have little or no faith in their parliament. The only institution that inspires less confidence than parliament is the judiciary, the performance of which three-fourths of the population finds unsatisfactory (Buehler 2009a). Corrupt judges and the absence of due process in administrative procedures means that the rule of law, one of the main objectives of the reform movement, is still not achieved.

Yet the conventional wisdom holds that Indonesia can grow at current rates and perhaps even faster if the government can achieve moderate improvements to the quality of public administration and target public investment more effectively. Quick wins, like removing bottlenecks in electricity generation and reforming the country's labor laws, would boost Indonesia's competitiveness in export markets and as a destination for foreign direct investment. A major effort to reform the bureaucracy and streamline regulations would reduce the incidence of corruption and create a more favorable environment for the development of small and medium sized firms.

As is often the case, the conventional wisdom is not incorrect, but it is incomplete. With its immense natural resource endowments, a young, hard-working population, prudent macroeconomic management and political stability, the Indonesian economy should post respectable rates of growth for the foreseeable future. However, Indonesia needs more than moderate growth if the country is to achieve its stated goal of becoming an "advanced and self-reliant nation by 2025." The main conclusion of this strategic assessment is that even at moderate rates of growth Indonesia is losing ground against its competitors in Asia and other regions. The existing growth model relies too heavily on over-exploitation of natural resources, does not invest sufficiently in people and fails to make the most of the opportunities presented by globalization. Grossly unequal distribution of the gains from growth breeds cynicism and despair. Millions of Indonesians do that feel that they have a stake in stability and democracy. Routine violations of human rights and due process chip away at the legitimacy of the state and alienate citizens from their government.

Indonesia's existing growth model does not take sufficient cognizance of the fact that the world is changing, and that old development strategies are no longer relevant to the era of globalized production. During the recent presidential elections candidates rushed to label their opponents as "neoliberals," squaring off for impassioned debates that would have been more appropriate to 1979 than 2009. The vital issue today is not "state versus market," but rather making both the government and markets work better to create an environment conducive to the development of technological and managerial capabilities. Government and business must work together to leverage foreign domestic investment and link into global supply chains. Indonesia cannot protect its economy from China, but must find ways to harness China's phenomenal growth in ways that creates opportunities to generate domestic value added.

If the country is to realize its national ambitions, *Indonesia must move beyond incremental reform to achieve a more fundamental transformation of its economic and political institutions*. While the achievements of the *reformasi* period are indeed impressive, the cultural, structural and institutional legacy of Guided Democracy and the New Order still weighs heavily on the country's economic, political and social life. The economy is still dominated by inward-looking oligopolies and state-owned enterprises, whose domestic profitability comes largely at the expense of international competitiveness and the working poor. Indonesia's democracy although open and competitive, is distorted by the legacy of the "floating mass" policy, which has driven a wedge of distrust and cynicism between politicians and the public. The urban middle classes, the groups that defend their democratic and civil rights most assiduously, still make up a small share of the population. Financial institutions and regulatory agencies favor large over small companies, locking in the economic polarization of the late Suharto period. "Bossism" and political gangsterism, including paramilitary organizations, have spread from the national to the local political scene. The politicization and commercialization of civil society groups such as non-government organizations and trade unions has further eroded the quality of public discourse. Citizens are not aware of their rights or how to defend them, and the authorities too often behave as if these rights did not exist.

The fundamental determinant of economic growth is the capacity of government and society to channel investment into productive activities and to close-off non-productive avenues of profit-seeking. Government must create a business friendly environment and at the same time act as an impartial referee, firmly yet fairly enforcing the rules of the game. But who will discipline the referee? Under democracy, the answer is the people, armed with the ballot, a free press and the rule of law. Yet democracy fails when votes, newspaper stories and judges can be bought with cash or favors or bullied through violence or the threat of violence. Having only recently emerged from three decades of the New Order, Indonesians are nearly unanimous in their preference for democracy over a return to military rule. Making democracy work is the only way forward. But this will mean reconstructing Indonesian citizenship in a way that empowers vulnerable groups, realizes their rights and impels politicians to redirect their energies from particularistic interests to the concerns of the wider public.

President Susilo Bambang Yudhyono's second term presents Indonesia with an excellent opportunity to move beyond *reformasi* to institutional transformation. The political situation is stable, the public is strongly supportive of reform, the government's finances are in order and the macroeconomic team has managed the recent global crisis with great dexterity. These are impressive achievements in their own right. In its second term, the Yudhoyono government can put in place the institutional prerequisites for growth, equity, democracy and rule of law that will serve the country for many years to come. This book makes the case for a concerted effort to transform the country's political and economic institutions over the next five years.

The book is structured as follows. Section I begins with the global context, and sets out the opportunities and challenges arising from globalization, the rise of China and the recent global economic crisis. Section II shows that although Indonesia's performance has improved in recent years, the country is still falling behind in terms of economic competitiveness and a range of social indicators. Section III analyzes key constraints to economic progress including over-reliance on natural resource exploitation, under-investment in people, over-regulation, misaligned public spending and distorted financial markets. Section IV presents the case for institutional transformation. The legacy of Guided Democracy and the New Order still shapes Indonesia's political and economic institutions despite the transition from authoritarianism to democracy. Overcoming this legacy will mean giving meaning to Indonesian citizenship, deconcentrating economic and political power and strengthening the rule of law. Section V concludes and presents a summary of policy recommendations.

1. The World is Changing

Half of the copybook wisdom of our statesmen is based on assumptions which were at one time true, or partly true, but are now less and less true by the day. We have to invent new wisdom for a new age.

John Maynard Keynes

The Global Business Revolution

Indonesia's strategic challenge is complicated by the fact that the global economy and business environment have changed dramatically over the past several decades. The advent of *reformasi* at home has coincided with a period of profound change in the world economy. Domestic discussion of economic policy is not yet sufficiently cognizant of these changes and the opportunities and constraints associated with them. Advances in production technology, cheaper transport and telecommunications and falling trade barriers have combined to globalize and fragment manufacturing into numerous discrete steps organized into value chains that stretch across the globe and are comprised of increasingly specialized and technologically sophisticated production niches. Agriculture and services have been transformed in similar ways. These changes are often referred to as "outsourcing," "modularity," "fragmentation of production" or "vertical specialization," and include not just intra-firm trade resulting from the relocation of multinational companies' production facilities, but also sub-contracting of product-specific materials and components to other firms (Feenstra 1998).

The global business revolution has changed production in three fundamental ways. First, the geography of production in manufacturing, services and agriculture is now more diffuse than in the past. Production of even simple items or components link together separate operations performed in distant locations. Geographically dispersed supply chains create opportunities for countries to break into new industries, but they also mean more intense competition from more players at every stage of production. Second, economies of scale in research, design, information management and finance have led to increasing concentration of control within specific industries. There are not only fewer auto assemblers now than in the past, but also fewer tire companies, auto parts makers and even fewer producers of automobile seats. Technological content, quality standards and the efficiency of production have advanced so quickly that most companies cannot handle the pace. The remaining "system integrators" wage an incessant arms race in research and development spending to avoid the disaster of losing touch with the technological frontier. Third, the boundaries between firms have blurred as these system integrator companies demand greater control over technologies, quality, cost and timing of delivery of components.

These changes mean that businesses and government are increasingly locked in a "Red Queen Game," in which they must run faster and faster just to stay in the same place. Global competition means that pressure has increased at every stage of production to improve designs, reduce costs and improve quality. In order to gain a foothold in global supply chains, Indonesian firms must constantly strive to reach the technological frontier while at the same time increasing efficiency and improving quality. Poor quality infrastructure, low levels of educational attainment and a stifling bureaucracy leave them at a great disadvantage relative to their competitors.

The revolution in manufacturing has rendered policies like infant industry protection less useful than they were in the past. Late industrializing countries like Korea and Taiwan used tariffs and subsidies to protect domestic producers from foreign competition until these companies could develop the technological and managerial capabilities needed to compete with global leaders. The rise of multinational systems integrator companies that dominate product technology, design, branding and marketing has narrowed the space for new entrants into many manufactured products. System integrators invest massively into research and development, design and branding, which protects them from competition from new market entrants. They use their market power to force suppliers to cut costs and improve quality. This results in further consolidation in industries producing components and materials at successive levels of the supply chain. Indonesia once dreamt of building a domestic airline industry and delivered huge subsidies to state-owned companies to achieve this goal. The challenge today is to compete in the intensively competitive global market for aircraft components. The latter goal requires more rather than less engagement with the world economy.

Systems integrators are locked in a technological arms race in which failure to invest sufficiently in research and development does not mean lower profits, it means bankruptcy.[5] For example, the number of independent automobile assemblers in the United States., Europe and Japan fell from 42 in 1960 to twelve in 2005. In the latter year the top ten producers accounted for 83 percent of the market. Each of the main assemblers spent from two to eight billion dollars per year on research and development of new products to make their cars lighter, more fuel efficient, safer and more attractive. According to the European Commission, three of the top five global companies by R&D spending in 2008 were auto assemblers.[6] Each assembler spends tens of billions of dollars on materials and components, and uses their market

[5]A recent example is the handheld device maker Palm, which until recently was a major competitor of Apple and Blackberry. Over the six month period beginning in November 2009, the company's stock price fell seventy percent and the firm was up for sale.

[6]Toyota was ranked first, with spending of 7.6 billion euros ($10.6 billion), followed by Volkswagen in third spot and General Motors in fifth. Figures quoted in the *Economist* newspaper's "Economic and Financial Indicators" on November 21, 2009 (p. 98).

power to force down suppliers' prices and improve quality. This has led to concentration among suppliers. Three parts companies (Delphi, Denso and Bosch) are far ahead of the pack, each spending more than two billion dollars on R&D per annum. Parts suppliers participate directly in the development of new technologies and in quality assurance at the point of assembly. The trend is replicated in tires, auto glass, seats and brakes (Nolan, Zhan and Liu 2008, 37). Developing countries that dream of building a national champion car assembler must ask themselves if they can improve on the technological content, efficiency or attractiveness of any of the remaining incumbent assemblers.

In the electronics industry, systems integrators organize modular production networks of contract manufacturers (CM) and original design manufacturers (ODM) and assemblers that in turn acquire the hundreds or even thousands of generic parts from other suppliers that go into a single product. Dedrick, Kraemer and Linden (2008) use the example of the Apple iPod (circa 2005) to demonstrate how the electronics supply chain works. Apple designed the iPod, developed the software (which eliminates expensive royalty payments) and distributes the product through their own retail chain. The authors estimate that Apple's gross margins from the 2005 thirty gigabyte video iPod was 36 percent. None of the supplier firms did nearly as well. The most expensive component is the hard drive, which at the time was produced by a Japanese CM (Toshiba) in China. The display module, made in Japan by a Japanese joint venture CM (Toshiba-Matsushita), was the second most expensive component. Neither of these components was new or high-tech, which meant that competition from other suppliers kept margins low. The microchip that controls the iPod's functionality was produced in the US or Taiwan by PortalPlayer, an American ODM. PortalPlayer could not drive up profits because of the company's dependence on Apple, which in 2005 accounted for 93 percent of sales. Indeed, when Apple switched suppliers the following year PortalPlayer suffered a huge drop in revenue and was eventually acquired by a larger chip producer. The video/multimedia processor was made in Taiwan or Singapore by Broadcom, a major US ODM. Hundreds of other less expensive parts and components were made in Japan, Korea and China by a range of suppliers and CMs. Final assembly was carried out in China by a Taiwanese company (Inventec) (Linden, Kraemer and Dedrick 2007).

The iPod example demonstrates the pressure on ODM and CM companies to achieve economies of scale and to invest in R&D at every level of the supply chain. Second and even third tier producers are large multinational companies that are engaged in product and process design and maintain their own supply chains, largely in Asia. New manufacturers must enter this system at the bottom, beginning with generic materials supplies and moving up into higher level components as technological and managerial capacity develops.

Even relatively low-tech, labor intensive sectors are not free from these pressures. Systems integrators in athletic footwear compete with each other by expanding the array of styles on offer and by rotating products in ever shorter seasonal cycles. They force CMs to compete with each other in reducing production times and improving quality. For example, Taiwanese contractors operating in China reduced the time required to produce a pair of shoes from 25 days to ten hours over the period 2002 to 2006 (Chang 2008, 113).

Globalized production presents developing countries with opportunities to break into new parts, component and assembly industries that were previously dominated by advanced countries. System integrators, ODMs and CMs are willing to share technology and involve suppliers in the development of new products and processes if this helps them to reduce costs or increase the pace of innovation. But to gain access to these opportunities firms must survive cutthroat competition involving numerous contenders from around the world. Cheap labor provides some advantages, but hardly enough to guarantee survival: on average, labor costs make up three to four percent of the FOB price of products shipped from the developing world to the United States, and 0.75 percent of the retail price (Berger 2005, 124). No wonder management consultants agree that cheap labor strategies are always a dead end.

The development of technological and managerial capabilities is the key to surviving the global business revolution. Some of these capabilities can be acquired locally the old fashioned way: learning by doing, reverse engineering and hiring experience workers from other firms. But in most cases the processes are too advanced, and learning times too truncated, to succeed using these methods. The best hope for developing country firms in many product lines is to develop strong linkages with multinational enterprises that have an interest in cultivating capabilities amongst their supplier firms.

Foreign direct investment (FDI) has grown in tandem with the global business revolution. Although FDI flows were down in 2009, the existing stock of FDI in developing countries soared from $529 billion in 1990 to $4.2 trillion in 2007, a rise of 13 percent per year on average. Inward investment is now a vital link to global supply chains and technological capabilities within and between firms. Intra-firm trade has risen to more than 35 percent of total world trade in goods as multinational companies diversify the location of their production facilities. Countries compete for investment not just on price but also on the availability of skilled labor, the density of domestic supplier industries, the quality of infrastructure and the transparency of business regulation. The issue is no longer simply the amount of foreign investment: increasingly middle income countries have focused their attention on the type and quality of investment.

Indonesia's size confers real economic benefits in the new, globalized world economy. The country's vast domestic market affords economies of scale to domestic producers and also attracts inward investment. Major multinational companies are aware that they need to be present in Indonesia now to establish themselves in what will eventually become an important market in the region. China has skillfully used access to its massive domestic market as leverage to pressure large systems integrator firms to locate production, research and design facilities in China. There is some evidence that this is happening in Indonesia as well. Foreign auto parts suppliers have shown a willingness to establish partnerships with Indonesian firms to establish a presence in what they forecast will be a major domestic market for automobiles. During the import-substitution era, assemblers were forced to partner with local companies to meet local content requirements. The result, however, was high-cost production and lack of export competitiveness. Foreign partners had no incentive to meet international standards of efficiency or quality, since they could pass higher costs onto domestic consumers. Now parts producers are still interested in the domestic market, but they must compete against imports and therefore can no longer rely on a captive market. Indonesian auto parts manufactures are now more efficient and are finding overseas markets for their products.

However, in other industries Indonesia is still wedded to the old model. The Ministry of Communications and Information Technology has imposed local content requirements of thirty to fifty per cent on the wireless broadband sector. New market access restrictions on pharmaceuticals require drug companies to manufacture locally or enter into partnerships with Indonesian firms in order to register products for sale in the Indonesian market. These policies may succeed in appeasing powerful domestic interests, but they move Indonesia away from the technological frontier in two important and dynamic industries.

The Rise of China

China's share of global GDP rose from 1.3 percent in 1990 to 7.3 percent in 2008 at current exchange rates. According to the World Bank, China accounted for more than eleven percent of global output in 2009 at purchasing power parity exchange rates. China's rapid growth presents a new set of challenges and opportunities to developing countries in Asia and other regions. ASEAN countries understand that they must compete with China in a diverse range of markets for manufactured goods and for inward investment. China is a ruthless competitor. Traders in Tanah Abang market claim that the price of made garments imported from China is equal to the price of cloth made in

Indonesia.[7] An undervalued exchange rate and massive economies of scale give Chinese companies a tremendous advantage.

However, the relationship between China and ASEAN is often complementary rather than competitive. China has emerged as the world's assembler, producing final electronic goods from components manufactured around the world, but mostly in Asia. As a result, China has grown rapidly in importance as an export destination for East and Southeast Asian countries. In addition to components, China is a major importer of minerals and other raw materials, fuel, food, capital goods and even some consumer goods (see Figure 1). China overtook the United States as ASEAN's third largest trading partner in 2008 (after Japan and the EU). China is now India's largest trading partner, absorbing nearly ten percent of India's exports, consisting among other products of ores and metals, yarn and textiles, chemicals, precious stones and machinery. China is also Korea's largest export destination, and in April of 2009 became Brazil's largest trading partner for the first time.[8] China's share of intra-regional trade in East and Southeast Asia rose from 31.7 percent in 1990 to 42 percent in 2008 (ADB 2009, 41).

China's growing demand for natural resources to feed its massive population and to supply its factories has supported global commodity prices even as demand in the rich countries slowed. The continuation of the global commodity boom despite the fallout from the global financial crisis was a life saver for much of the developing world. Countries from Indonesia to Chile were able to sustain growth in a year in which other sources of growth faltered.

China will increasingly supplement the United States in its role of "consumer of last resort." Millions of middle class Chinese consumers now have money to spend on durable goods. They will not buy the same things as American consumers, but some of what they do buy will come from Southeast Asia. Chinese consumers will import South-

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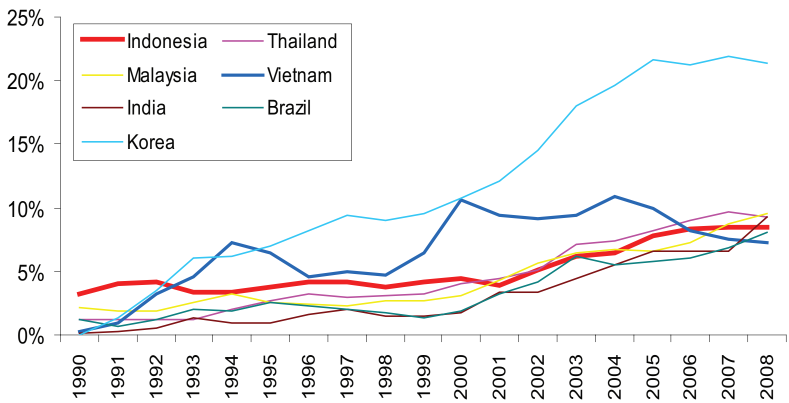
[7]"Chinese Textile Products Too Cheap, Claim Jakarta Traders," *Jakarta Post*, January 3, 2010.

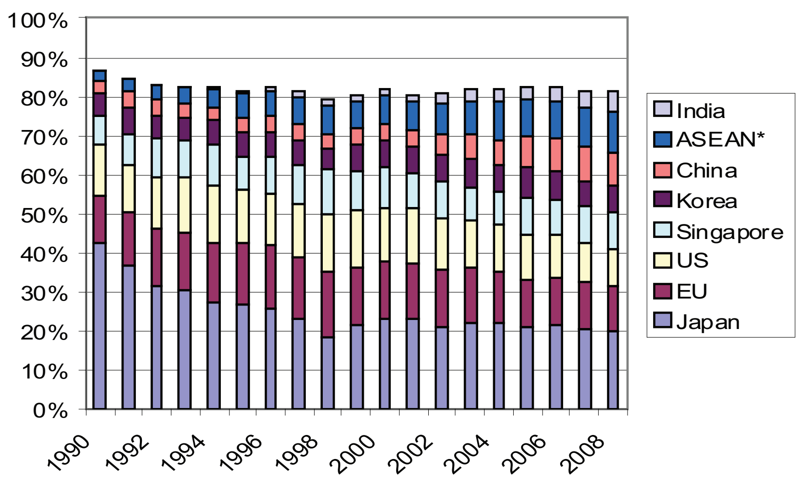
[8]Brazilian exports of grain, soybeans, iron and oil to China continued to increase rapidly in 2009 (Duffy 2009).

Figure 1. Exports to China as share of total, selected countries



Source: IMF Direction of Trade Statistics

Figure 2. Export destinations, selected countries



Source: IMF Direction of Trade Statistics

east Asian seafood, gemstones and furniture. Chinese outbound tourist numbers grew by 20 percent per year from 1997 to 2007, and the World Tourism Organization predicts that by 2020 China's outbound tourist volume will be the largest in the world. Four Southeast Asian countries ranked among the top ten destinations for Chinese tourists in 2007: Vietnam, Thailand, Singapore and Malaysia.[9]

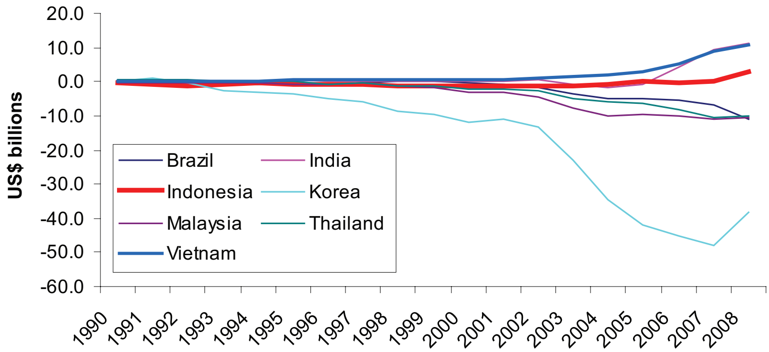
However, the rise of China as an export destination does not mean that Asia is somehow "decoupling" from the West. Take Indonesia as an example. While it is true that exports to China, India and other ASEAN countries have increased as a share of total exports, much of this increase has come at the expense of Japan (another Asian country) and not the European Union or the United States (see Figure 2). More importantly, many of China's imports consist of raw materials and components that receive further processing before being sent to their ultimate destinations in the US and Europe. Although intra-regional trade is growing at an impressive rate, much of the demand for these goods actually originates from outside the region (Park and Shin 2009).

China's niche in world markets is evident from its bilateral trade balances (Figure 3). China's trade deficits with raw material producers like Brazil have increased in recent years. Over the past decade, China's trade deficit with Korea has also swelled, reaching nearly $50 billion before receding in 2008. China remains heavily dependent on Korea, Japan and Taiwan for access to capital equipment, components and some consumer goods. Countries that combine natural resource and component exports like Malaysia, Thailand and the Philippines also run trade surpluses with China.

India, Vietnam and Indonesia currently run trade deficits with China. All three countries import Chinese manufactures and export primarily raw materials. It is not a coincidence that these three countries are not deeply embedded in global supply chains for manufactured goods, particularly electronics, which are assembled in China. The problem for these countries is that as the pace of technological

[9]Hong Kong and Macau were considered as overseas destinations and were top of the list. The other countries in the top ten were Japan, Korea, Russia and the United States (Tse Sze Ming 2009, 22)

Figure 3. China's trade balance with selected trading partners



Source: IMF Direction of Trade Statistics

change accelerates at every level of global supply chains it becomes more difficult to penetrate component industries.

The ASEAN China Free Trade Area (ACFTA) came into being on January 1, 2010. ASEAN countries stand to benefit from lower tariffs for their exports to China, which averaged 8.9 percent in 2007. ACFTA is also more likely to help agriculture, food and technology-intensive components more than heavy manufactures. As the former are more likely to be produced in ASEAN countries, and the latter in China, we expect that the agreement will help countries like Indonesia and Vietnam to reduce their trade deficits with China, and countries like Thailand, Malaysia and the Philippines to increase their trade surpluses (Park, Park and Estrada 2009).

Nevertheless, ACFTA is running into political opposition in Indonesia, and other ASEAN countries. The Indonesian government has apparently made a commitment to renegotiate the trade deal in response to pressure from trade associations.[10] Indonesian manufactur-

[10]"FTA Worries Some," Straits Times, January 6, 2010, http://www.straitstimes.com/BreakingNews/ SEAsia/Story/STIStory_474038.html (accessed January 6, 2010). "18 Asosiasi Tidak Siap Hadapi FTA [18 Associations Not Ready for FTA]," *Kompas*, January 19, 2010. p. 17.

ers are worried that they will not be able to compete with imports of Chinese consumer and capital goods.

The other important aspect of China's growing economic power is financial. China acquired massive holdings of U.S. financial assets during the boom years to keep the RMB from appreciating and to finance America's widening trade deficits. These holdings are a mixed blessing. They are a politically sensitive problem for China's government owing to public concern that over-investment in U.S. assets leaves China vulnerable to a large depreciation of the dollar. Internationally, China is under pressure to allow the RMB to strengthen to boost Chinese imports and reduce pressure on competitors.

However, China's massive foreign exchange holdings are also a source of power. China is acquiring overseas assets, especially natural resources. China is also attempting to diversify its asset portfolio by making dollar loans to oil companies in Russia, Brazil and the Middle East with provision for repayment in oil (Wade 2009, 546). Such deals are likely to multiply in the future as China seeks to ensure access to vital natural resources, particularly food and fuel.

China is also acquiring gold and Euros, but cannot do so at rates that would destabilize markets for these assets. Although China has expressed its support for strengthening the reserve currency role of IMF SDRs, this will not provide a workable solution to the dollar problem. SDRs are not a sufficiently liquid asset to achieve wide usage, and thus the dollar is likely to remain the main medium of international payments for the foreseeable future (Eichengreen 2009).

The Global Crisis of 2008-2009

The economic crisis of 2008/09 has also left its mark on global economic trends. The boom years were financed by the willingness of US consumers, companies and the government to borrow, and for the Chinese and other Asian countries to provide cheap finance. Low interest rates contributed to the under-pricing of risk and over-leveraging in the US. Those days are over. Americans are deleveraging at rapid rates, and will continue to do so until debt to output ratios return to levels recorded in the 1990s. But there is still quite a lot of deleveraging to do: at the end of 2008, the nominal value of debt in the US was five times GDP. This was an all-time high, greatly in excess of the previous record of three times recorded at the height of the Great Depression of the 1930s (Tymoigne and Wray 2009, 9).

Deleveraging in the private sector implies either larger government deficits or a smaller current account deficit.[11] There are political limits to the size of the federal deficit, and as the US moves towards mid-term elections in 2010 we can expect calls to reduce public spending and the size of the fiscal deficit. By definition, American trade deficits must shrink, and this is likely to be achieved through the steady depreciation of the US dollar (and revaluation of the Chinese RMB). Consumers in the United States will no longer serve as the engine of growth in Asia (Bergsten 2009, 21).

For the past decade, Asian countries have exported and saved. For the region as a whole, exports increased from 37 to 47 percent of GDP. Household savings rates have remained high because the dependency ratio of the population is low (the share of those out of the labor force is small relative to those in the labor force) and also because of the absence of social safety net programs and low levels of public spending on education and health. As a result, Asian households from China to Indonesia have had to save between ten and thirty percent of household income to provide for their children's' education and to "self-insure" against the risks of income loss due to poor health or old age (Klein and Cukier 2009). High rates of domestic savings translate into low rates of domestic consumption: hence the heavy reliance on export demand.

This is why social policy is central to Asia's economic prospects. Asian countries will rely on domestic demand to pick up some of the

[11]In fact there is a third possibility, which is rapid debt deflation and a decline in national income. Given that this is even less politically acceptable than large budget deficits, we rule it out as a viable option.

slack from falling or static exports to rich countries. Transfers to the poor can achieve some of this, but it is unlikely that transfers will be carried out on a scale sufficient to affect aggregate demand. Pensions and health insurance are a more effective means of freeing up domestic spending because they reduce the need for costly (and largely ineffective) self-insurance. Asian governments will also introduce policies to promote small and medium scale enterprises and other programs to support the growth of the domestic middle classes. These policies have positive political effects as well, which we discuss in Section V below.

2. Indonesia is Losing Ground

'Well, in OUR country,' said Alice, still panting a little, 'you'd generally get to somewhere else—if you ran very fast for a long time, as we've been doing.'

'A slow sort of country!' said the Queen. 'Now, HERE, you see, it takes all the running YOU can do, to keep in the same place. If you want to get somewhere else, you must run at least twice as fast as that!'

Lewis Carroll, *Through the Looking Glass*

Like Alice in the Red Queen's race, countries attempting to boost their competitiveness at a time of rapid economic change often find that they have to run as fast as they can simply to stay in the same place. Indonesia is changing, but many of the dynamic economies of East Asia are changing faster. Indonesia is losing ground to China, Vietnam, Thailand, Malaysia, India and the Philippines in foreign direct investment flows, manufacturing, infrastructure and education. The only sector in which Indonesia is more internationally integrated than its peers is finance, but economists are divided as to whether early financial market integration is a good thing for development (Kose *et al.* 2006). Despite some progress, Indonesia's basic social indicators still lag behind other middle income countries.

It is reasonable to ask why Indonesia has not done better. It lives in a good neighborhood, with several very fast-growing nations nearby. It has not had a major external or civil war since the 1960s. Its natural resources generate income that could be used to educate the population, build and maintain infrastructure and improve health and productivity. Investment has been low since the late 1990s and social spending has been miserly. While Vietnam has grown at nearly eight percent over the past two decades, Indonesia has averaged only 5.5 percent *even if the large drop in output in 1998 is ignored.* If the 1998 collapse is included, annual per capita growth is barely over two percent since 1990. Its share of world exports in 2007 was lower than in 1977 or 2000.

The evidence presented in this section is at odds with some of the more optimistic assessments of Indonesia's economic situation. As noted in the introduction to this book, the optimistic scenario is not incorrect but it is incomplete. Indonesia has grown faster than many middle income countries over the past decade, and has continued to do so over the past year. Indonesia has suffered less during the recent crisis because it is less dependent on exports than some of the more outward-oriented countries in the region. The commodity boom that began in 2003 has been a tremendous advantage.

But domestic consumption and high commodity prices are not an adequate basis on which to build a prosperous society. Indonesia must improve its hard infrastructure and its technological and managerial capabilities if it is to develop a wider range of competitive industries. It must adapt to the global business revolution and use foreign investment to link to global markets and acquire cutting edge technologies. It must learn to translate economic gains into social progress, to build an inclusive and more equitable society that gives people a stake in stability and democracy.

This section makes the case that Indonesia has underperformed in economic and social terms. Over-reliance on natural resources and underinvestment in health, education and large-scale physical infrastructure have deep roots in the country's political economy, stretching back to the colonial period and continuing through early independence and the New Order. What is surprising is that these long-established patterns have intensified during the *reformasi* era. The advent of a more open and democratic political system has not been accompanied by a renewed emphasis on efficiency, equity and sustainability. We will consider some of the reasons for this continuity in later sections. Part of the problem is a political complacency that can be traced to lack of awareness within government and the wide public of Indonesia's poor performance relative to other countries in the region. The main point of this section is that this complacency is not warranted, and that the evidence indicates that Indonesia is falling behind its main competitors in terms of economic preparedness and social progress.

Competitiveness

The competitiveness of national economies can be measured in a variety of ways. Some indicators, for example "revealed comparative advantage," look at trade outcomes. The World Economic Forum's Global Competitiveness Report considers factors that promote or inhibit trade and investment such as skill levels, infrastructure, and the quality of regulation and government institutions. None of these approaches can be considered comprehensive in their own right, but each adds something to our understanding of the factors that strengthen and undermine competitiveness in individual countries.

Indonesia was ranked 54 out of 133 countries in the 2009-2010 World Economic Forum Global Competitiveness Report, which placed Indonesia considerably ahead of the Philippines (87) and Vietnam (75), but behind Malaysia (24), China (29), Thailand (36) and India (49). Less important than the rankings themselves are the individual indicators of competitiveness included in the report (see Figure 4). Indonesia ranks 16th in market size—reflecting the advantages of bigness discussed in the previous section—but is losing ground in five key areas: technological readiness (88), infrastructure (84), health and primary education (82), labor market efficiency (75) and higher education and training (69). We will have more to say about each of these four components of competitiveness later in this section and in the remainder of the book. However, the main point is clear: Indonesia has underinvested in physical infrastructure and in health and education.

Like the other large economies of Southeast Asia, Indonesia relied almost exclusively on natural resource exports until the mid 1980s. At that time, a fall in global commodity prices combined with the Plaza Accord exchange rate adjustments led to a shift in strategy away from natural resource dependence and towards exports of labor-intensive manufactures based largely on inward investment from Japan, Korea and Taiwan. Exports of manufactures from Indonesia grew at an average annual rate of 16.5 percent from 1991 to 1996 (Table 1). Although the statistics are inflated by the sharp rise in plywood exports (plywood is a manufactured good) following the ban on exports of raw timber, exports of other goods also increased quickly. The optimism resulting from the region's newfound success in exporting manufactures was one of the factors motivating the over-borrowing and overinvesting that ultimately led to the East Asian financial crisis of 1997.

Figure 4. WEF Global Competitiveness Report 2009-2010, Indonesia rankings

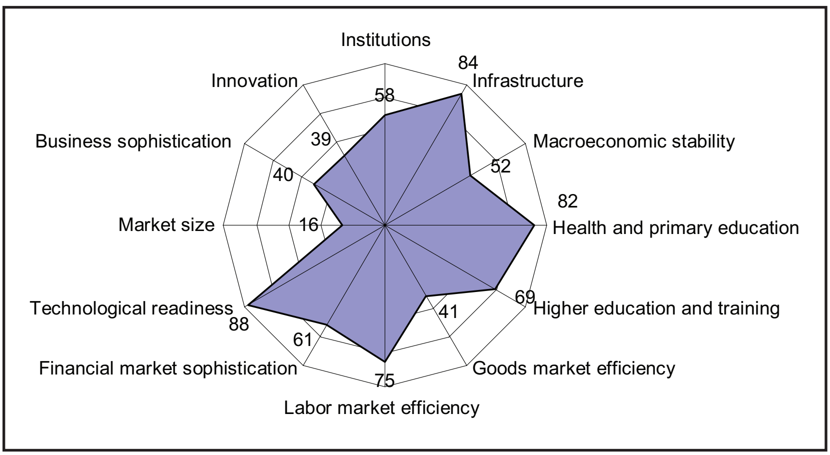


Table 1 shows that growth of manufactured exports slowed during the crisis period and its immediate aftermath, which also covers the period of the 2001 economic slowdown in the United States. However, in most of the region the period from 2003 to 2007 was one of renewed expansion: growth of manufactures grew by 28 percent per year in China, 15 percent in Thailand and a remarkable 21 percent in Vietnam. Even India (17 percent) and Brazil (16 percent) made impressive strides in exporting manufactures. Although Indonesia's six percent growth was faster than that recorded during the crisis period, it was considerably slower than the country's own pre-crisis record and inferior to other countries in the region with the exception of the Philippines.[12]

Table 1. Growth of manufactured exports, selected countries

	1991-1996	1997-2002	2003-2007
Indonesia	**16.5%**	**3.4%**	**6.4%**
Brazil	5.2%	2.4%	16.3%
China	16.9%	13.3%	27.6%
India	8.7%	5.8%	17.3%
Korea	9.0%	3.2%	14.3%
Malaysia	22.0%	2.7%	7.9%
Philippines	40.7%	10.7%	3.4%
Thailand	16.0%	2.7%	14.6%
Vietnam	--	13.6%	21.3%

Source: Authors' calculations from World Development Indicators

These trends are also evident in Figure 5, which presents the composition of exports for four large Southeast Asian countries including Indonesia.[13] After 1990, manufactures dominate exports in Thailand, Malaysia and even newcomer Vietnam. Indonesia also records a large upswing in manufactured exports, reflecting policy changes from the

[12]Philippine electronics exports were hit by an appreciation in the real exchange rate in 2006 and 2007.

[13]Data for the Philippines are not available. The time series for Vietnam commences in 1997.

mid-1980s designed to encourage investment in labor-intensive manufactures and FDI. However, manufactures never assumed the central role in Indonesia's export profile that they did in neighboring countries.

Another trend apparent in Figure 5 is the renewed importance of natural resource exports from the region in recent years. As discussed in the previous section, China has affected Southeast Asia's export profile in three ways: as a competitor in labor-intensive industries; as an importer of raw materials; and as an importer of intermediate goods, largely manufactured components. As shown in the figure, the main impact on Indonesia has been the increased demand for natural resources and competition from imports of labor-intensive manufactures. Indonesia is not yet a significant exporter of components to China.

One way to view these trends is through revealed comparative advantage, which measures the intensity of a country's exports of a specific good relative to the intensity of world exports of the same good.[14] Ian Coxhead (2007) has conducted an interesting experiment in which he has compared the revealed comparative advantage (RCA) indices of Southeast Asian countries against those of China for the period 2000-2004. He concludes based on these bilateral comparisons that Indonesia shows a particularly strong tendency toward reverting to reliance on natural resource exports (Table 2). While Vietnam is competitive in footwear, and Malaysia in appliances and office machines, Indonesia's main strengths are vegetable oils, wood products, natural gas, coal, rubber and minerals.

Should Indonesians care that their comparative advantage is now concentrated in natural resource exploitation rather than manufacturing? Does it make any difference to the country's development

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[14] Revealed comparative advantage (RCA) index is calculated for countryc, good *g* and time *t* as $RCA_{cgt} = \frac{X_g^c / X_G^c}{X_g^W / X_G^W}$, where G

denotes the sum of all exports from country *c* or from the world *W*. An RCA of greater than one means that the share of commodity *g* in the exports of country *c* in a given year is greater than the share of the same commodity in world exports. This signals that the country has a comparative advantage in the production of the commodity.

outcomes? There are reasons to believe that it does. Outside of a few countries with large oil reserves per capita, no rich countries are dependent on natural resource exports. Productivity is generally higher and productivity growth more rapid in manufacturing than in other sectors due to the scope for technological change and greater possibilities for increasing returns to scale. Industry provides greater scope for backward and forward linkages, for "learning by doing" and technological spillovers between firms and industries (Syrquin and Chenery

Table 2. RCA bilateral comparisons with China, 2000-2004

	Indonesia	Vietnam	Thailand	Malaysia
Vegetable fats and oils, refined	14.2	0.5	0.3	13.1
Cork and wood manufacture, excluding furniture	7.6	-0.4	-0.2	2.0
Gas, natural and manufactured	7.4	-0.1	0.3	3.2
Crude rubber	7.4	13.8	18.0	5.1
Coal, coke and briquettes	5.6	-1.3	-3.3	-3.3
Metallifarous ores and metal scrap	4.5	0.2	0.2	0.0
Animal and vegetable fats and oils, processed	4.2	-0.0	0.9	17.0
Coffee, tea, cocoa, spices	3.9	6.7	-0.2	0.4
Pulp and waste paper	3.8	-0.0	0.6	-0.0
Fish, crustaceans, etc.	1.8	10.5	5.8	-1.3
Paper and paperboard	1.8	-0.1	0.2	-0.1
Petroleum and petroleum products	1.6	2.5	0.2	0.8
Cork and wood	1.1	0.2	0.2	2.4
Sugar and sugar preparations	0.1	0.4	4.3	0.0
Cereals and cereal preparations	-0.5	3.7	2.5	-0.5
Meat and meat preparations	-0.5	-0.4	1.3	-0.5
Electrical machinery and appliances, nes	-0.6	-0.8	0.5	1.8
Footwear	-1.4	7.0	-1.0	-4.3
Office and data processing machines	-1.5	-1.9	0.5	1.3

Source: Coxhead 2007

1989). The income elasticity of demand for many manufactured goods (though not all) is higher than for primary products in most years. In other words, as people get richer they buy more electronic gadgets and cars but eat the same amount of rice and drink the same amount of coffee.

This should certainly not be taken to mean that countries should discriminate against agriculture and agricultural exports, as Indonesia's own economic history shows (Gelb 1988, 197-226). Moreover, producers of natural resources can increase domestic value added by encouraging domestic processing of raw materials and improving quality, for example transitioning from low grade to premium coffee. But it does suggest that over-specialization in natural resources can be a dead end.

To explore the idea that competition from neighboring countries in manufactures and increased Chinese demand for raw materials has had an impact on Indonesia's competitiveness, we have conducted an exercise to compare Indonesia's trade performance over a longer period of time. Following Palma (2009), we analyze exports along two dimensions: competitiveness, which measures the extent to which a given country's exports are increasing as a sharing of world imports; and dynamism, or the extent to which a country's exports are concentrated in goods that are growing as a share of world imports. We plot competitiveness on the x-axis and dynamism on the y-axis. Our two reference periods are 1971 to 1983 and 1995 to 2007. Countries that have increased market share in a larger proportion of exports—in other words, that have become more competitive—move from left to right in the figure. Countries that have increased their share of dynamic exports move from bottom to top.

The results are presented in Figures 6 to 7 (see the notes following Figure 8 for more details). India, which has emerged from import substitution to re-engage with world markets, shows the largest increase in competitiveness among the countries included in our sample. Malaysia and the Philippines also show a trend towards greater competitiveness.[15] However, both of these countries are increasingly specializing in non-dynamic commodities, in other words goods that are not growing as a share of global imports. Nevertheless, for these countries China's rise has not been associated with a decline in overall competitiveness.

The picture is less positive for a second group of countries, which includes Indonesia (Figure 7). Other countries in the group are Thailand, Brazil and Korea. These countries have seen their competitiveness decline sharply in the recent period. In Indonesia's case, the share of exports that have gained market share fell from 92 to 67 percent. Korea's loss of competitiveness is directly attributable to competition from China in a wide range of manufactured products. However, Korea's large trade surplus with China (Figure 3) reflects the close interdependence of manufacturing in the two countries.

Figure 7 also indicates that Indonesia and Brazil's exports are more dynamic in the recent period. However, this result is not the product of a move into exports of manufactures with a high income elasticity of demand. Instead, it reflects the sharp increase in commodity prices during the post-2003 period, which has seen spending on raw materials increase as a share of total imports.[16]

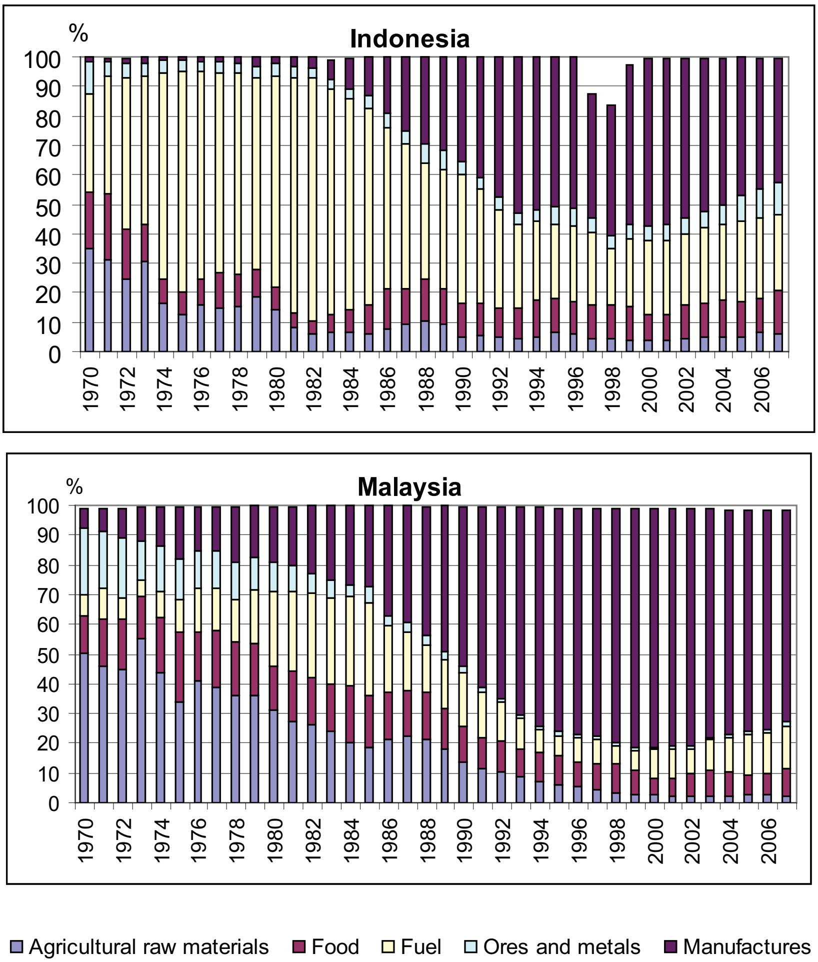
This point comes out more clearly in Figure 8, which presents the top ten dynamic exports for each country. The figure reveals the extent to which countries have been able to diversify into a range of dynamic exports, encompassing manufactures as well as natural resources. China's dynamic exports are led by technology-intensive goods like telecommunications and optical equipment but also include furniture, base metals and textiles. Malaysia's dynamic exports include machinery and equipment of various kinds but also vegetable oil and precious

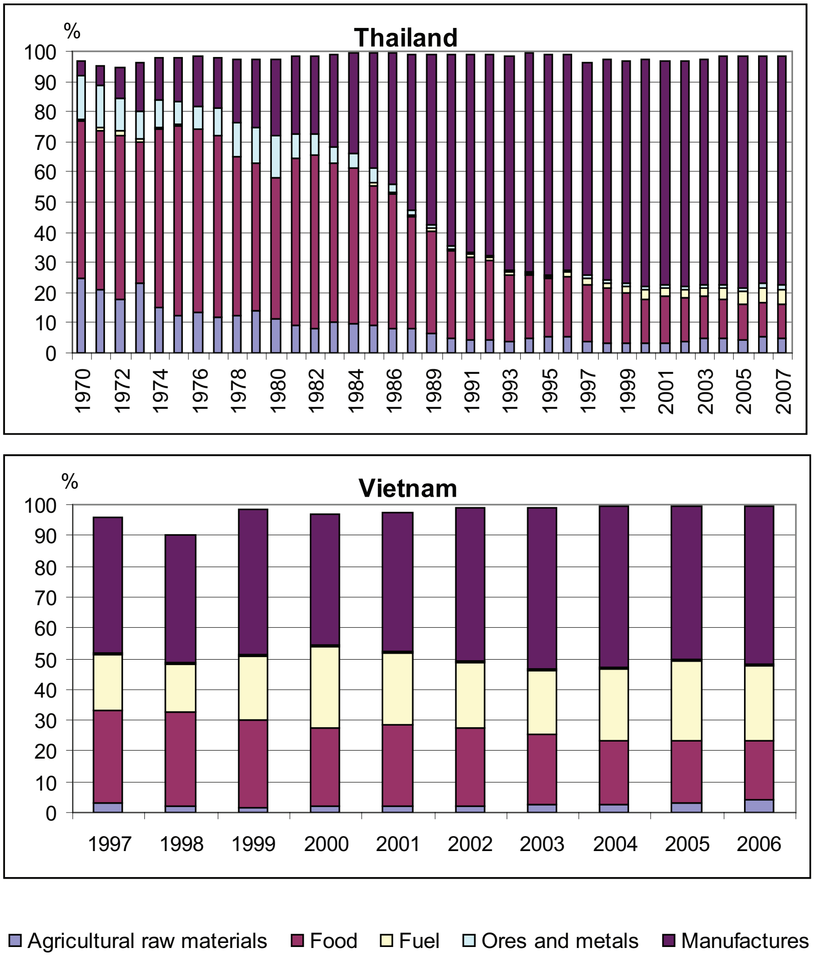
[15]Since data are not available for China and Vietnam prior to the 1990s, we are unable to plot the first reference period for these countries. However, results from the current period accurately reflect China's exceptional competitiveness, with 98 percent of Chinese goods increasing market share during the reference period.

[16]Fuel would also fit into this category, but these commodities have been dropped from the analysis to reduce bias from fluctuations in oil and gas prices.

metals. Thailand's automotive parts industry accounts for the largest share of dynamic exports, but the country also exports telecoms equipment, chemicals and precious metals and gems. The Philippines also records a diversified portfolio of ores and metals, machinery and equipment, textiles, furniture and vegetable oils.

Figure 5. Composition of Exports, 1970-2007





Source: World Development Indicators

Figure 6. Competitive and dynamic exports, selected countries

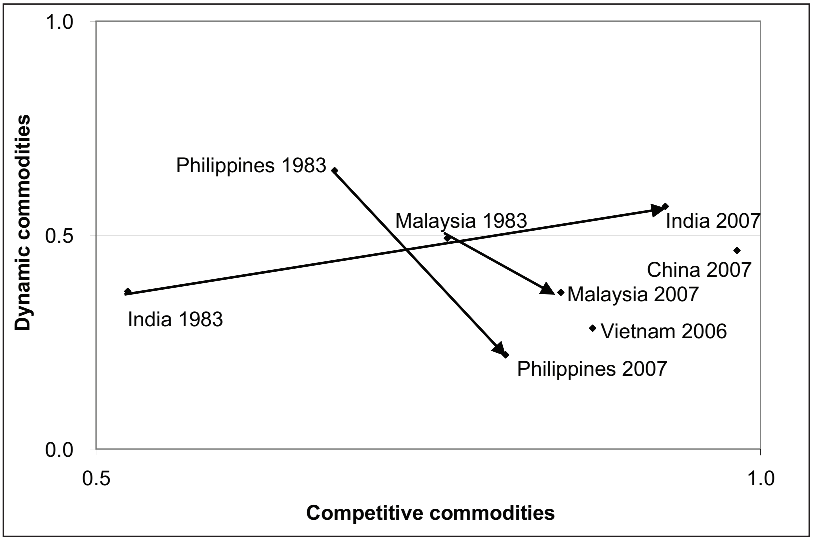


Figure 7. Competitive and dynamic exports, Indonesia and selected countries

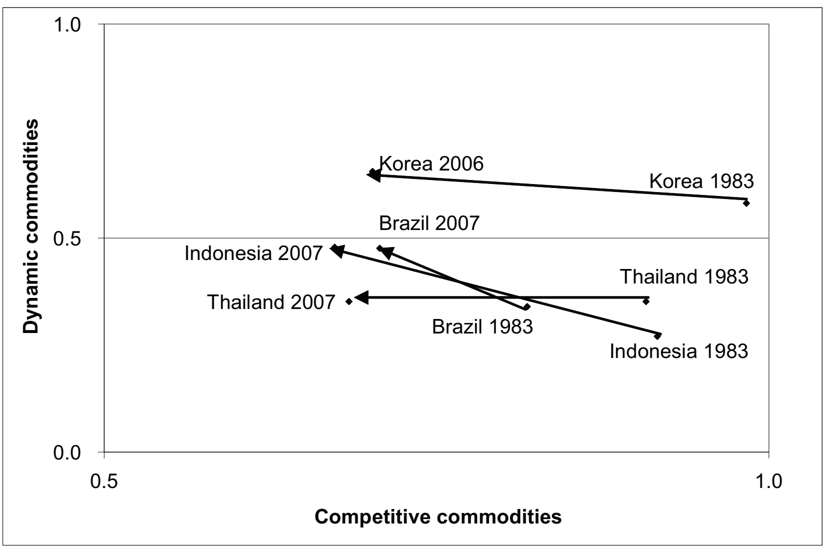
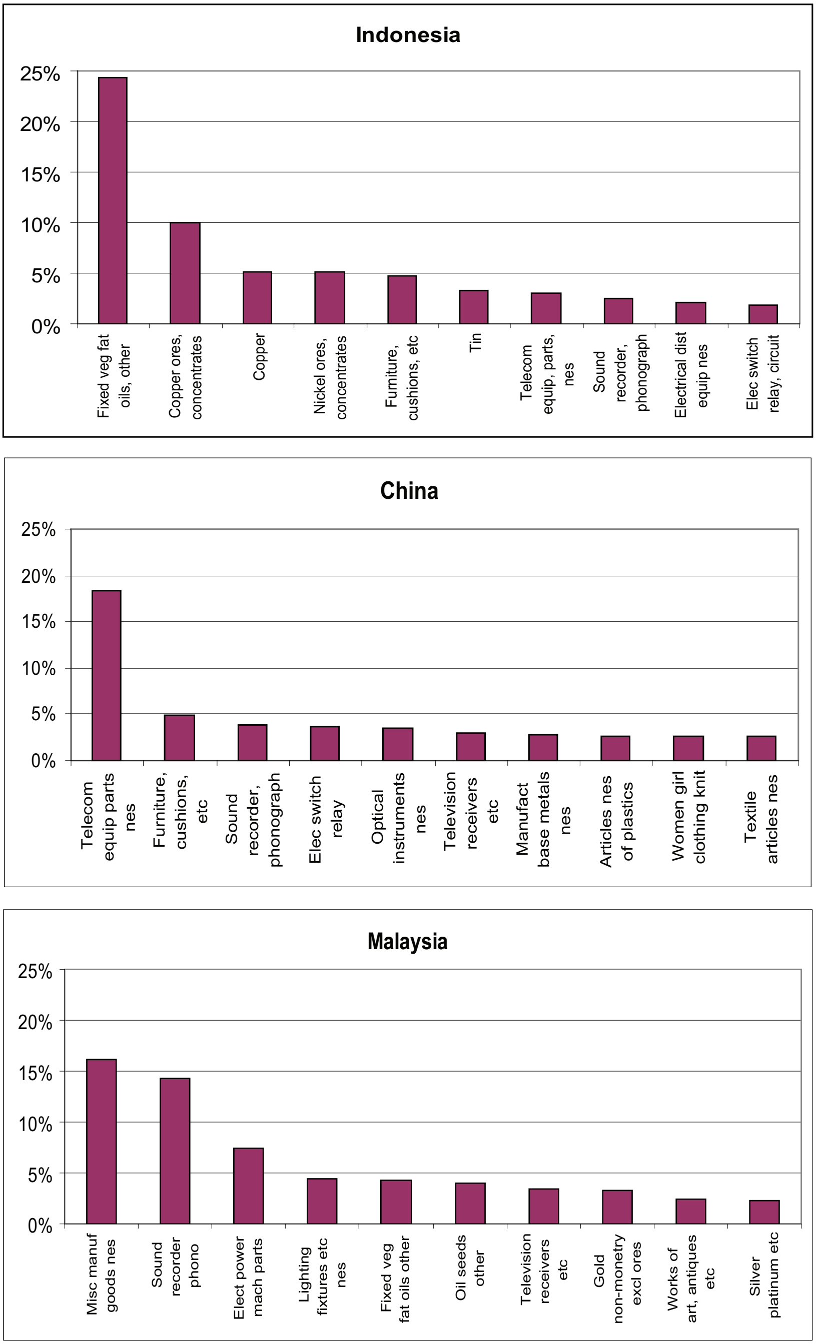
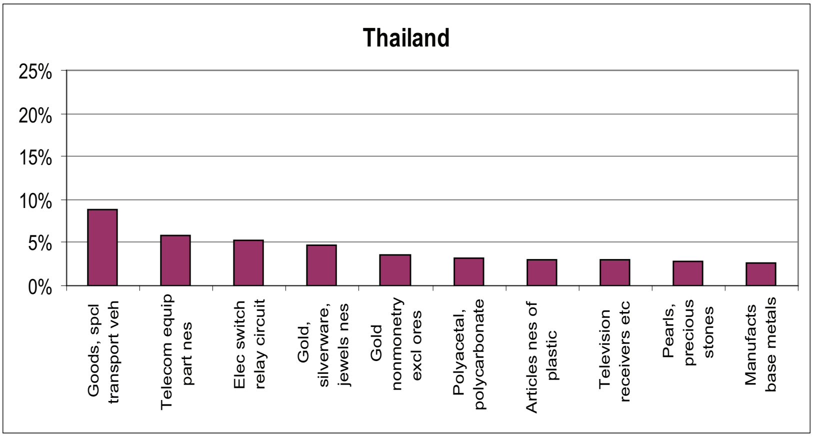
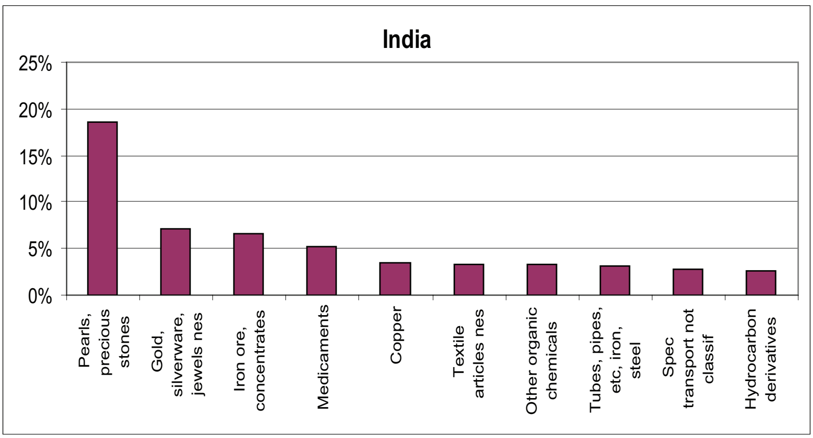


Figure 8. Distribution of dynamic commodities in 2007, selected countries




Thailand
25%
20%
15%
10%
5%
0%
Goods, spcl transport veh
Telecom equip part nes
Elec switch relay circuit
Gold, silverware, jewels nes
Gold nonmonetry excl ores
Polyacetal, polycarbonate
Articles nes of plastic
Television receivers etc
Pearls, precious stones
Manufacts base metals


India
25%
20%
15%
10%
5%
0%
Pearls, precious stones
Gold, silverware, jewels nes
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Medicaments
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Textile articles nes
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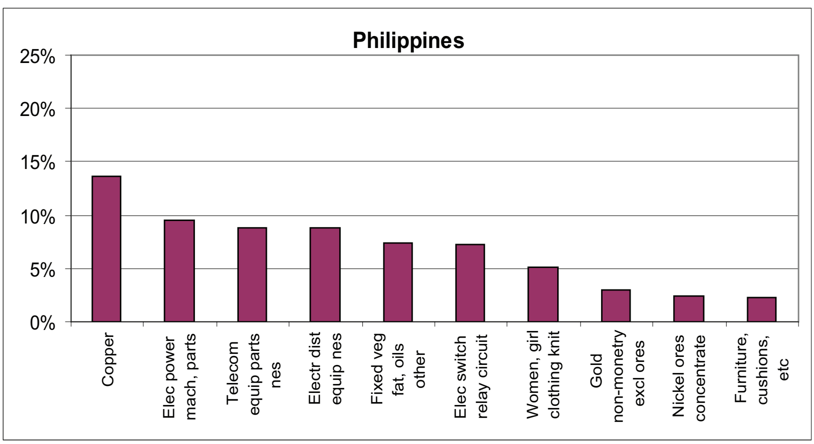
Spec transport not classif
Hydrocarbon derivatives


Philippines
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Telecom equip parts nes
Electr dist equip nes
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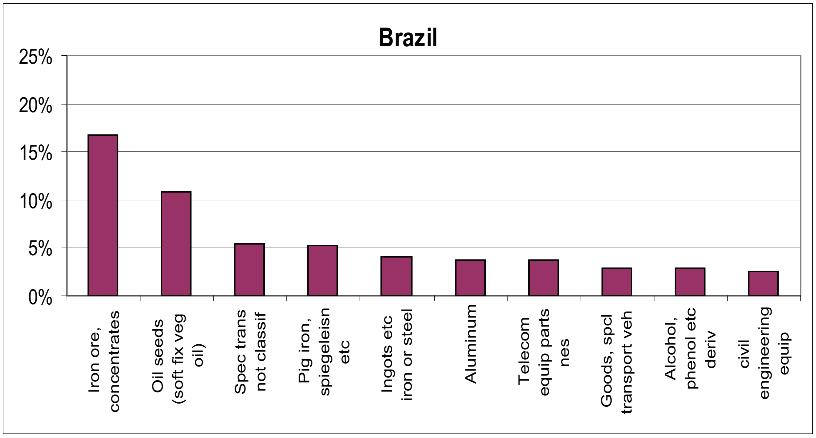
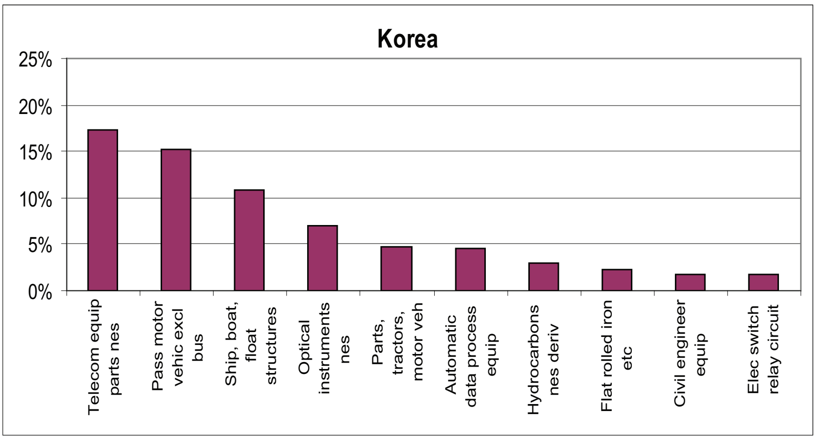
Elec switch relay circuit
Women, girl clothing knit
Gold non-monetry excl ores
Nickel ores concentrate
Furniture, cushions, etc





Notes to Figures 6 to 8:

Figures 6, 7 and 8 divide exports from selected countries into "competitive" commodities and "dynamic" commodities. Competitive commodities are defined as those exports *from a given country* that have gained global market share over the reference period. Dynamic commodities are defined as *commodities that account for a rising share of global trade* over the reference period.

In Figures 6 and 7, the x-axis measures the share of each country's competitive exports over total exports. The y-axis measures the share of dynamic exports over total exports. Movement from left to right means that a larger share of the country's exports has increased market share over the reference period. Movement from bottom to top means that a larger share of the country's exports is dynamic, or in other words that the country is specializing in goods that are increasing as a share of global exports.

Figure 8 presents the ten most important dynamic commodities measured as share of total dynamic exports for each country in the second reference period.

The reference periods are 1971 to 1983 and 1995 to 2007. Each reference year is calculated as a three year average. The data were obtained from UN Comtrade SITC Revision 1 for the first period and SITC Revision 3 for the second period (all at the three digit level). Data are not available for China and Vietnam for the 1971 to 1983 period. Korea had not yet reported 2008 exports at the time of this writing, and thus the reference year of 2006 was adopted (meaning a three year average of the period of 2005-2007). The Comtrade series for Vietnam begins in 1995 and ends in 2007 (at the time of this writing). The reference years for Vietnam are therefore 1996 to 2006 (or three year averages of 1995-1997 and 2005-2007).

Oil and coal have been excluded in an attempt to adjust for the rapid rise in fuel prices in the latter reference period.

Indonesia's over-specialization in a limited range of natural resource-based exports comes out clearly in Figure 8. Vegetable oils account for nearly 25 percent of the country's dynamic exports, the highest level of concentration in one commodity within the sample. The addition of two metals—copper and nickel—brings the total to 45 percent. These commodities have limited scope for productivity improvements and linkages to the rest of the economy. Although China's demand for raw materials is likely to keep commodity prices buoyant, over-specialization does increase the risk of income fluctuations due to price swings. Indonesia could also experience the re-emergence of "Dutch disease" effects, in which a natural resource boom induces an

Table 3. Top Twenty Exports to China, Average 2006-2008 (USD millions)

	Indo-nesia	Brazil	India	Malay-sia	Philip-pines	Thai-land	Viet-nam
Fruit, veg, rice, fish and shellfish	-	-	-	-	26	666	373
Oils and oilseeds	1,536	3,950	-	2,798	23	-	-
Rubber and materials	737	-	-	1,294	-	1,940	763
Wood, pulp and paper	903	622	-	134	-	199	106
Ores and metals	744	4,286	5,712	157	405	-	122
Petroleum products, natural gas and coal	3,851	1,126	303	508	119	1,301	1,110
Chemicals and plastics	324	563	509	786	38	1,555	-
Footwear, leather, cotton, textiles and yarn	-	447	811	-	-	-	59
Machinery and equipment	155	-	-	1,135	984	3,364	58
Telecom parts, transistors, switches	-	-	-	4,531	3,401	2,067	-
Other	-	112	513	1,661	40	-	311
Total	8,249	11,106	7,848	13,003	5,037	11,092	2,903

Source: UN Comtrade

appreciation in the exchange rate, thereby discouraging exports of labor-intensive manufactures.

How could Indonesia benefit more from China's rise and minimize the negative impact on its competitiveness? From the perspective of the global business revolution, opportunities to develop technological capabilities are strongly associated with linkages to complex, modularized production systems. These vast networks of producers, assemblers and systems integrators increasingly dominate production of high value added and dynamic manufactured goods. China has emerged as the main assembly center within these networks (Arthukorala 2009). If we look more closely at China's imports, we see that some countries in the region—for example, Malaysia, Thailand and the Philippines—are closely linked to China's assembly and production networks. Table 3 shows the top twenty exports of selected countries to China. The countries divide roughly into countries that export mostly raw materials to China (Indonesia, Vietnam and Brazil), those that export mostly components and equipment (the Philippines) and those that manage to do both (Thailand, Malaysia and India).

China's rapid rise also presents opportunities for lower middle income countries like Indonesia, the Philippines and Vietnam to substitute domestic production for imports from China. It is surprising that oil and coal producing Indonesia still imports a billion dollars worth of petroleum products and coke from China. Perhaps even more alarming is the $200 million in fruit, vegetables and prepared foods that Indonesia imports from China (Table 4). The point is not that Indonesia should use tariffs and quotas to protect itself from Chinese goods, since this would simply reduce Indonesia's competitiveness by raising input and food prices. However, the Indonesian government can and should remove bureaucratic and infrastructural obstacles to domestic production of these goods and provide targeted (and time-bound) incentives if appropriate.

Table 4. Top Twenty Imports from China, Average 2006-2008 (USD millions)

	Brazil	India	Indo-nesia	Malay-sia	Philip-pines	Thai-land	Viet-nam
Machinery and equipment	2,357	4,303	1,083	3,138	545	1,642	690
Telecom parts, transistors, switches	2,293	3,601	1,189	5,120	1,592	2,205	626
Motorcycles, auto parts	295	-	380	-	110	-	614
Chemicals and fertilizers	501	1,671	204	-	211	353	463
Medicines		771	-	-	-	-	-
Fabrics and yarn, garments and footwear	595	798	807	1,146	342	357	1,280
Petroleum products, coke	620	295	1,004	-	143	-	693
Iron and steel, other metals	-	1,486	1,003	170	545	1,200	1,804
Vegetables, fruit, food prep	-	-	199	387	-	-	-
Other	335	-	-	556	304	212	-
Total	6,996	12,926	5,869	10,517	3,793	5,968	6,171

Source: UN Comtrade

Indonesia can benefit tremendously from China's demand for raw materials. But to sustain growth over the long term, Indonesia must leverage China's growth to develop its own technological and institutional capabilities. This does not mean discouraging raw material exports, or protecting domestic producers from competition from Chinese imports. Instead, the government must remove obstacles to domestic investment and productivity growth. In particular, Indonesia must find ways to link into modularized global production systems centered on China but also linking to systems integrators in Europe, North America and Japan, and component producers and assemblers in Southeast Asia. Breaking into these networks means more than anything else resolving the institutional and human capital constraints that have discouraged foreign direct investment in Indonesia, and developing national technological capabilities in high value and dynamic export products.

Foreign Direct Investment and Manufacturing

The nature of manufacturing has changed dramatically over the past two decades. Globalization and fragmentation of production have created extensive and complex value chains, within which pressure has increased at each level to innovate, reduce costs, improve quality and reduce production times. These trends are evident in the expansion of world trade, which as grown more than six fold since 1980, and has more than doubled since 2000. Intra-firm trade now accounts for about 35 percent of total world trade in goods. Increasingly, foreign direct investment is the best entry route for developing countries into the world of fragmented and modularized production. Multinational companies bring capital, technology, management, skills and access to external and internal markets. They also generate demand for domestically produced inputs, and in many cases invest time and money in helping local firms achieve the cost and quality standards necessary to enter into global supply chains.

The quantity of foreign direct investment has soared as the global business revolution has taken hold. The existing stock of FDI in developing countries rose from $529 billion in 1990 to $4.2 trillion in 2007, an average increase of 13 percent per year. The capacity created by these investments has broken down the traditional division of labor in which rich countries produced manufactures and poor countries sold primary commodities. The developing world's share of manufactured exports rose from 5.5 percent in 1970 to nearly one-third in 2006. Asia accounts for three-fourths of the total volume of manufactured exports from the developing world.

In Indonesia, rapid growth of manufacturing in the 1980s and 1990s was driven by FDI in labor-intensive industries. Indonesia's stock of inward investment expanded more than four fold from 1985 to 1996. Athukorala (2006) calculates that multinational enterprises accounted for 62 percent of manufactured exports for the years 1990-1994. FDI doubled again between the years 1996 and 2007 (see Table 5). Although the stock of FDI per capita and relative to gross domestic product is smaller in Indonesia than in many other emerging economies, this is partly a product of the country's size. In relation to the size of the economy, FDI in Indonesia is larger than in India and China although less than Brazil.[17]

Of course, all FDI is not created equal. FDI falls roughly into three groups: investment in natural resources for export and the domestic market; investments oriented towards the production of other goods and services for the domestic market; and other export-oriented ventures. These categories are not mutually exclusive, and as trade barriers fall—for example, as ASEAN countries liberalize trade in consumer products under the ASEAN Free Trade Area (AFTA)—the distinction between investments directed toward domestic markets and exports will become increasingly blurred. Nevertheless, the economic impact of the different kinds of FDI varies in important ways. From the perspective of the global business revolution, foreign investment in technology-intensive component manufacturing and assembly establishes vital linkages between the domestic economy and dynamic intra and extra-firm export markets. These firms bring stable and relatively high-paying jobs, new technological and managerial capabilities, create demand for domestic supplier industries and have the potential to

[17]Inter-country comparisons of FDI stocks and flows are not always reliable because countries adopt different definitions and measurement standards. For example, numerous authors have pointed out that China's FDI statistics are exaggerated because a large share of inward investment consists of Chinese capital that has made a "round trip" between China and Hong Kong. In recent years round tripping FDI may account for as much as forty percent of the total (Naughton 2007). Indonesia has its own round-tripping FDI consisting of domestic capital that has left the country for Singapore and returned as inward investment, but we do not have reliable estimates of the magnitude of this phenomenon.

move into innovation-intensive activities such as product design and research and development.

Table 5. Foreign direct investment in selected countries

Country	Stock of FDI (USD billions)			FDI stock per capita (USD)	FDI stock as % GDP	Ratio FDI 2007/1996
	1985	1996	2007	2007	2007	
Indonesia	5.7	26.9	59.0	261	14%	2.2
Brazil	27.9	54.8	309.7	1,630	23%	5.7
China	6.1	128.1	327.1	248	10%	2.6
India	0.7	8.2	76.2	68	9%	9.3
Malaysia	7.4	36.0	76.7	2,350	41%	2.1
Philippines	1.8	11.7	20.0	226	14%	1.7
Thailand	2.0	19.7	85.7	1,339	39%	4.4
Vietnam	1.4	10.1	40.2	473	57%	4.0

Source: UNCTAD

Indonesia's FDI is concentrated in production for its large domestic market and natural resource exploitation, and not in the production of manufactured exports. According to data published by the government's Investment Coordination Board, about half of inward investment was directed to industry over the period 2005 to 2007, the rest going to agriculture, mining, oil and gas and service industries such as building the domestic telecommunications networks.[18] Less than ten percent of FDI went into the "metals, machinery and electronics" category, the group most closely associated with the dynamic information and communication technology (ICT) sub-sector.

Another way to view the extent of a country's linkages to global manufacturing value chains is through world market share. Table 6 presents statistics showing Southeast Asian countries' share of world machinery exports for the years 2003-2005 compiled by Arthukorala

[18]These figures are available from the Badan Koordinasi Penanaman Modal (BKPM) and published on their website http://www.bkpm.go.id/.

Table 6. Share of World Machinery Exports, 2003-2005

	Indonesia	Malaysia	Philippines	Singapore	Thailand	Vietnam
Power gen. machines	0.1	0.1	0.1	0.5	0.3	0.0
Special indust machinery	0.2	0.5	0.1	0.9	0.2	0.1
Metal-working machines	0.0	0.2	0.1	0.9	0.3	0.0
General industrial Machines	0.2	0.4	0.1	0.7	0.8	0.1
Office machines	0.3	6.7	1.8	5.3	2.5	0.0
Telecom and sound equip	1.0	3.9	1.1	1.3	2.9	0.1
Electronic machines	0.4	6.7	4.4	4.6	1.8	0.2
o/w Semi-conductor devices (SITC 776)	0.2	7.3	4.8	4.8	1.6	0.0
Road vehicles	0.2	0.3	0.2	0.1	0.5	0.0
Other trans equipment	0.0	0.1	0.1	0.7	0.1	0.0
Total	0.3	3.8	2.0	2.7	1.4	0.1

Source: Arthukorala, 2008

(2008). As production of these goods is largely carried out by affiliates of multinational companies or under contract to these firms, these figures provide an interesting perspective on the use of foreign direct investment in the region. The statistics show that unlike the rest of the region, Indonesia and Vietnam are not yet involved in these industries in a significant way.

Later in this book we address some of the factors that make Indonesia less attractive than other emerging economies to multinational companies seeking to invest in manufacturing. These include bureaucratic obstacles to investment and conducting operations, corruption, security concerns and a shortage of skilled workers. Indonesia's bureaucracy seeks to maximize extraction over the short period rather than facilitate investment for long term growth. Meanwhile, the country has under-invested in its people, and allowed its educational institutions to focus on quantity rather than quality. Another important factor is that Indonesia has fallen behind its competitors in terms of providing access to quality infrastructure, which is the subject of the next sub-section.

Infrastructure

The poor quality of Indonesia's infrastructure is a major constraint on competitiveness. The 2009 Global Competitiveness Report ranks Indonesia 96th out of 133 countries, behind Zimbabwe and slightly ahead of Albania and the Philippines (World Economic Forum 2009, Table 2.01). Although the country did not perform well on any of the WEF infrastructure indicators, the worst problems were identified as roads, ports and the supply of electricity.

Indonesia's first toll road was built in 1978 and covered the approximately 50 kilometer stretch from Jakarta and Ciawi. Over the next thirty years Indonesia added less than 700 kilometers. Plans for a cross-Java highway have not yet been realized. By way of comparison, Malaysia now operates more than 1,500 kilometers of toll roads (Surjadi and Kiki 2009).

It is difficult to comprehend how an archipelagic nation like Indonesia could tolerate outmoded and inefficient seaports for such a long period of time.[19] According to a report by the USAID-funded, "SENADA" project for economic competitiveness, Tanjung Priok—the country's leading port—can handle forty-five container moves per hour (MPH). This is about half of the capacity of Singaporean and

[19]The WEF ranks Indonesia 95th out of 133 countries in port infrastructure. The Philippines, the other archipelagic country in Southeast Asia, ranks 112th. Vietnam was ranked 99th in the same report (World Economic Forum 2009, Table 2.04).

Malaysian seaports (Ray 2008, 11). The same report claims that due to delays in cargo handling, many ships must leave Tanjung Priok before vessels are fully loaded into order to keep to published schedules. Shipping lines are cutting back on capacity planned for the Jakarta port as a result.

Lack of access to adequate and reliable supplies of electric power is one of the most serious problems faced by domestic and foreign investors in Indonesia. Indonesia increased its electricity supply by ten percent per year from 1990 to 2000 even though real GDP grew only four percent per year. This rate of growth implies that demand for electricity increases by 2.5 percent for every one percent rise in GDP. In this decade, GDP growth has averaged five percent per year, implying that electricity supply should have risen by 12.5 percent per year. Actual electricity output in 2008 was 150 billion kilowatt hours (kWh), but a 12.5 percent annual increase since 2000 would have resulted in total output of 240 billion kWh. However, even this estimate is probably too low. PLN officials suggest that the electricity shortfall is actually 40 to 47 percent of electricity demand, which implies that the supply required to avoid rationing in 2008 would have been between 250 to 283 billion kWh in 2008. If economic growth reaches or exceeds six percent per year in 2010, supply must grow by a further 35 to 40 billion kWh per year. This would imply about 400 billion kWh demand in 2012.

The current plan would add 10,000 MW by 2012, and would increase installed capacity by 40 percent.[20] But output would have to be about eighty percent higher now to satisfy existing demand. If GDP expands at an average rate of six percent over the period 2010-12, then electricity demand would have to grow a further fifty to sixty percent from 2008 to 2012. In other words, the plan to add 10,000 MW by 2012 must be doubled if Indonesia is to eliminate shortages within a few years.

[20]Indonesia's 25 thousand MW capacity operates about 6,000 hours per year on average to produce 150 billion kWh. A 10 thousand MW expansion, at 6,000 hr/year, would produce 60 billion kWh more.

But where is the government going to find the funds it needs to double investment in power generation? The existing 10,000 MW plan will cost $17.3 billion. If the domestic electricity price remains well below the cost of production, each jump towards adequate capacity will cost the public sector billions of dollars in subsidies—additional spending that the government cannot afford. PLN cannot sign more contracts with private power producers if the government cannot afford the subsidy costs of the electricity consumed.

It might be possible to reduce the demand for electricity per unit of output by investing in more efficient machinery and technologies. But Vietnam, with higher electricity prices and lower per capita income, produced 664 kWh per capita in 2007 against only 588 kWh per capita in Indonesia. This suggests that Indonesia needs a good deal more capacity and it has absolutely no way to pay for it without using its current consumption subsidies (running over $7 billion in 2009) for capital investment. If the $7 billion in subsidies were used as equity for 33 percent of new investment, and debt used for the other two-thirds, the entire investment in 10,000 MW could be financed and, with realistic prices, paid for over time without any additional burden on the budget.[21] In other words, electricity subsidies mean much higher debt and a larger burden on the public sector even if electricity shortages are only reduced and not eliminated.[22]

The inescapable conclusion is that the politically unacceptable option of reducing electricity subsidies must be made acceptable. There is no way that Indonesia can begin to supply adequate amounts of power without moving prices closer to actual costs. As with fuel price

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[21]Cumulative 2006 to 2009 subsidies are over $20 billion, enough to pay completely for the 10,000 MW plan or, with an equal amount of debt, to pay for over 20,000 MW.

[22]The overall average capital cost for the ongoing 10,000 MW package is $1730 per KW. It is 12 percent hydro, 48 percent geothermal, 14 percent gas and 26 percent coal. Combined cycle gas generators cost about $900 per KW and coal with scrubbers in the US costs $1900 per KW. Hydroelectricity costs $1500 to $2000 per KW and geothermal costs run from $1600 to over $3000 per KW depending on the site and size of the generator. While diesel generators cost very little to install, they use 0.25 to 0.3 liters of diesel fuel per kWh of power, and at a world market diesel price of 70 cents per liter, have a variable cost of 20 cents per kWh.

increases, there can be a "lifeline" provision for the poor. For example, the first 50 kWh per month could receive a highly subsidized rate, and more realistic prices charged for heavier use.

This is bound to be unpopular with the middle classes that now run their air conditioners cheaply. What might make it acceptable, if not welcome? The government could sweeten the pill by making a commitment to reduce burdensome and unpopular blackouts. If PLN can deliver reliable electricity at a higher price, it would be more palatable than just higher prices. A second approach would be to pay part of the cost of more efficient air conditioners or refrigerators. This has been done in other countries, as utilities are allowed to put these costs into their cost base. The utility often finds it is cheaper to reduce electricity demand through the spread of more efficient appliances than it is to supply power to inefficient appliances. By subsidizing efficiency, consumers will see benefits from the new policy and would be able to reduce the impact of higher prices on consumption. A third approach, already being adopted, is to use more geothermal energy. If geothermal power can attract carbon credits, it would be cheaper to use.[23] Geothermal, with or without carbon credits, is much cheaper than diesel generators. Explaining this clearly might help to persuade at least some families that the new policy is more responsible and a better long term bargain. Finally, as the energy shortage is reduced, the funds now used for the subsidy could be used for roads, education and health. These other benefits could be identified and sold as part of the bargain.

While regions that have access to coal, natural gas, hydroelectricity or geothermal power sources have fairly low generating costs, those regions relying on diesel or oil thermal have very high costs. Regional equity may dictate that until a grid or more efficient local power can be put in place, some Outer Island provinces may need to be subsidized more than others relative to cost. While Java, Bali and parts of Su-

[23]If annual capital and amortization costs are 10 percent of capital costs, geothermal should cost about 5-6 cents per kWh to produce and additional amounts to distribute. Carbon credits would reduce this.

matra have achieved power costs of Rp. 1,050-1,200 per kWh, in other provinces power costs range from Rp. 1,660 to 4,000 per kWh. These high cost provinces account for only about 15 percent of total electricity supply, and as more geothermal and other low cost sources are brought in, the use of high-cost power should lessen. But low-cost areas should pay their way, even if higher prices are phased in gradually.

One real bonus of a reformed electricity policy would be to allow factories to focus on production rather than worrying about managing around power outages. Indonesia's ability to attract new investment would improve greatly if this fundamental barrier could be overcome. A nation that cannot provide adequate power is suspected of being inadequate in other important ways. Banishing these doubts would improve the lives of ordinary people and also the reputation of the entire nation. An improved policy is long overdue.

Box 1. Infrastructure Tops Investors' Concerns

"In the past, legal uncertainty used to be the number one issue" for investors, said Fauzi Ichsan, an economist at Standard Chartered bank. "Now it's weak infrastructure."

Years of under-investment in roads, transport, power and water have exacted a heavy human and economic price. In March 2009, a dam burst on the outskirts of Jakarta, sending a wall of water through a residential area, killing about a hundred people and destroying or flooding hundreds of homes. The dam dated from the Dutch colonial period and had not been properly maintained.

In early 2009, the government launched a Rp. 73.3 trillion stimulus package, including spending on infrastructure, to increase domestic demand as exports slumped. But spending has been slow. One of the problems is the complexity of the approvals process at the central and local levels of government. Another is that the sweeping powers of the Corruption Eradication Commission (KPK) to investigate graft have deterred civil servants from involvement in construction contracts.

A report published by the Asia Foundation in 2008 concluded that "unreliable and expensive road transportation is a growing constraint on Indonesia's development" (Asia Foundation 2008b). The costs of licensing vehicles, road charges, bribes, accidents and the cost of maintaining vehicles because of poor road maintenance increased the cost of road transport relative to other countries in the region.

Indonesia also suffers from blackouts and power failures because of underinvestment in electricity generation. Only 60 percent of the government's crash program to build 10,000 megawatts of coal-fired power plans is likely to be completed by 2011 because of financing shortfalls.

Source: Adapted from Davies 2009

Jobless Growth

Indonesia's post-crisis recovery has gathered pace since 2000. Nevertheless, the rate of employment growth has been disappointing. Job creation is the most effective and sustainable means of reducing poverty and economic inequality. The availability of work also promotes social cohesion by giving young people—particularly young men living in or migrating to cities and towns—a stake in the success of the community. Indonesia must create jobs fast enough to absorb the 2.2 million new labor force entrants every year *and* find jobs for the ten million people who are currently unemployed. Moreover, many of the people listed as gainfully employed are working short hours in low productivity jobs. Employment growth remains a massive challenge.

Job growth in Indonesia is slower than in other large middle incomes countries. Table 7 reports employment growth figures available from the International Labor Organization for other Southeast Asian countries and Brazil.[24] The performance of the Indonesian economy

[24]ILO does not publish comparable figures for China and India.

has been particularly poor with regards to generating waged employment, which is the most direct and effective means of reducing poverty.[25] Manning points out that during the *reformasi* era half as many jobs are created for every one percent rise in GDP as compared to the pre-crisis period (Manning 2008, 13). The number of employees is growing slowly relative to own account workers, suggesting that labor force entrants are crowding into low productivity occupations like petty trade in the absence of good jobs.

Table 7. Employment growth 2002-2007 (percentage)

	Indonesia	**Brazil**	**Malaysia**	**Philippines**	**Thailand**	**Vietnam**
Total employment growth	1.62	2.99	2.01	2.38	1.74	2.10
Employees	2.02	3.73	1.75	3.30	3.07	--
Employers	0.68	1.30	3.35	-1.26	2.55	--
Own account workers	2.25	-0.47	3.28	2.04	1.75	--
Contributing family workers	0.11	-0.86	1.67	1.29	-0.62	--

Source: ILO Labor Statistics (http://laborsta.ilo.org/)

Slow job growth is the human side of low rates of investment and loss of industrial competitiveness. Table 8, which reports the sectoral breakdown of employment growth since 2002, reveals that new jobs are more likely to be created in the non-tradable sector than in tradable goods like agriculture and manufacturing. Employment growth in mining has been rapid, but from a small base, as mining accounts for only one percent of total employment and is unlikely to absorb much more labor in the future. Thus the bulk of job growth is oriented to

[25]See, for example, Sender 2003; Sen and Ghosh 1993 and Ghose 2004 for evidence from India; and Khan and Riskin 2001 for evidence on the relationship between access to waged employment and poverty and inequality in China.

the domestic market, and its potential is limited by the scope for domestic demand to increase. It is also striking that manufacturing still accounts for only twelve percent of employment, and that although the rate of job growth in this sector accelerated in 2007-2008, the overall performance for the period is weak. Improving international competitiveness, in particular in sectors like manufacturing, is the key to more rapid job creation.

Papanek and Chatib Basri (2010) differentiate between “real jobs” and “work and income sharing jobs.” The former consist of jobs with positive marginal productivity and are therefore created to satisfy genuine demand for labor, while the latter are a response to an over-supply of workers. They estimate that of the 22 million workers who entered the labor force between 1997 and 2008, only 5.6 million found real jobs. The rest were unemployed, left the country in search of employment or took up low or zero productivity jobs as family laborers or in low return, largely informal occupations like petty trade and services.

Table 8. Employment growth in Indonesia, 2002-2008 (Percentage)

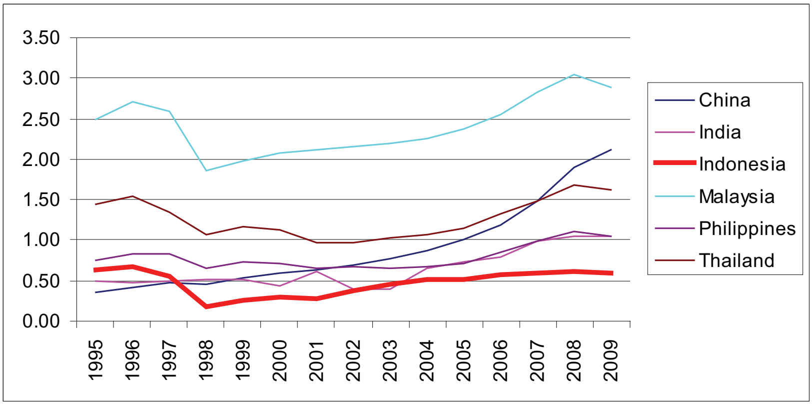
	2002-2006	2007-2008	Share (2008)
Tradables	-0.2	1.5	54%
Agriculture, forestry and fisheries	-0.3	0.9	41%
Mining	11.5	6.8	1%
Manufacturing	-0.5	3.2	12%
Non-Tradables	2.8	6.2	46%
Construction	2.5	5.9	5%
Trade	2	5.3	20%
Transport and Communications	5.3	4.7	6%
Utilities and other services	3	8.4	14%

Source: Chowdury et al. and author’s calculations

Why has job growth been so slow during the *reformasi* period? Employer and business associations have focused attention on the cost of hiring workers, particularly the high rates of severance pay mandated in Manpower Law 13 of 2003. Mandatory lump sum severance payments tripled from 2000 to 2003 (Manning and Roesad 2007, 66). An attempt to revise the law in 2006 met with stiff opposition from labor unions, and the changes were promptly shelved. The incident underscored the power of organized labor during the *reformasi* era, which, on the positive side, has created pressure to step up enforcement of labor laws that were routinely disregarded during the New Order. On the negative side, union power has created an "insider-outsider" problem, in which formal sector workers raise entry barriers and thus inadvertently force job seekers into casual employment. Employers resort to short term contracts to circumvent the law, which reduces job security and productivity. Firms are less likely to invest in training of short-term employees, who also are denied more important benefits like health insurance and pensions.

Another factor is minimum wages, which are now set regionally under the decentralization laws. This was a key factor in the early years of *reformasi*, when unit real labor costs rose quickly from the lows recorded during the crisis. Labor costs regained 1996 levels by 2002 as regional authorities put up minimum wage levels to gain support from organized labor. However, real wages have stabilized and even fallen in some locations and industries (Chowdhury et al. 2009, Figure 7). This is partly due to non-enforcement of minimum wage laws, and tremendous regional variation in minimum wages under decentralization. Data compiled by the Economist Intelligence Unit suggests that although wages have risen they are still low compared to other countries in the region (Figure 9). However, unit labor costs are higher than hourly wage costs due to the severance pay requirements mentioned above.

Figure 9. Hourly labor costs (US dollars)



Source: Economist Intelligence Unit

As we have seen, wage levels are just one factor in international competitiveness, and for most products they are not decisive. Higher productivity levels support higher wages, even in labor intensive manufactures. Regulations that discourage hiring, low skill levels in the labor force, administrative obstacles to opening businesses and engaging in international trade and poor infrastructure are the key obstacles in Indonesia to raising productivity growth and attracting foreign and domestic capital into export-oriented manufacturing. Macroeconomic factors, particularly an overvalued real exchange rate and persistently high real interest rates, are also important. These issues will be discussed in greater detail in the following section.

Health and Nutrition

Indonesia has reported good progress in lowering child and infant mortality rates.[26] According to UNICEF, under-five mortality fell from 86 per thousand in 1990 to 41 in 2008 (Table 9). Although this marks a considerable improvement over a short period of time, other coun-

[26]Child mortality as defined is the death of a child under five years of age, while infant mortality refers to children under one year of age.

tries in the region have done better. Thailand's under-five mortality fell from 32 to just 14 over the same period, and the rate in Vietnam dropped from 56 to 14. An Indonesian child is now nearly three times as likely to die before his or her fifth birthday as a Vietnamese child.

Child survival is affected by a number of factors. Lack of easily accessed, affordable and good quality health care, malnutrition and dirty water and poor sanitation facilities are all major causes of infant and child death. No one would claim that these are easy problems to solve. Still, there are few better measures of state capacity than the coverage and quality of public intervention on behalf of children. From this perspective, Indonesia's government is falling behind even some of its poorer neighbors. Indonesia's performance in a few key areas has actually deteriorated during the *reformasi* era.

Vaccination coverage is easy to measure and relatively easy to achieve. It requires periodic and timely interventions, but large numbers of children can be treated by a limited number of staff if they are adequately resourced and trained. Yet Indonesia is not performing well in comparison with other countries in the region. Data published by

Table 9. Child mortality, selected countries (rate per 1,000 live births)

	Under five mortality		Infant mortality	
	1990	2008	1990	2008
Indonesia	**86**	**41**	**56**	**31**
Brazil	56	22	46	18
China	46	21	37	18
India	116	69	83	52
Malaysia	18	6	16	6
Philippines	61	32	42	26
Thailand	32	14	26	13
Vietnam	56	14	39	12

Source: UNICEF

the World Health Organization reveal that Indonesia is trailing other middle income countries in Southeast Asia as well as Brazil and China (Table 10). Decentralization has slowed progress as many district governments have attached a low priority to the delivery of local health services, with the result that health centers and clinics are understaffed and underfunded (UNICEF 2008, 39).

Table 10. Immunization of one year-olds, percent, 2000 and 2008

	Measles		DPT3		Hep B	
	2000	2008	2000	2008	2000	2008
Indonesia	**72**	**80**	**75**	**75**	**65**	**74**
Brazil	99	99	98	99	94	95
China	85	94	85	93	72	92
India	54	67	68	62	--	6
Malaysia	88	90	95	96	94	87
Philippines	80	92	79	87	19	88
Thailand	94	96	97	98	95	96
Vietnam	97	83	96	92	--	67

Source: WHO World Health Statistics 2009

Another major cause of infant and child death is dehydration resulting from ingestion of contaminated drinking water. Data from the World Health Organization (Table 11) show that Indonesia's progress in providing clean drinking water in rural areas has been slow since 1990, and that access to improved sanitation has actually decreased over the same period. Whereas 42 percent of the rural population had access to improved sanitation facilities in 1990, only 37 percent did by 2006. Although statistics for urban areas suggest better coverage, UNICEF reports that 84 percent of samples from shallow wells in Jakarta were contaminated by fecal coliform. High rates of in-migration to the city mean that a growing share of the urban population is at risk from contaminated drinking water.[27]

[27]http://www.unicef.org/indonesia/wes.html, accessed December 6, 2009.

The direct result of slow development of essential infrastructure and low immunization rates is additional deaths from diarrheal and infectious diseases in Indonesia (Table 12). Nearly one-fifth of child deaths are due to diarrheal diseases, and a shocking 4.7 percent is due to measles. Polio re-emerged in 2005, for the first time since 1996. According to UNICEF, one in five districts is at high risk from maternal and neonatal tetanus. Meningitis, encephalitis and typhoid are still prevalent. Taken together, these indicators constitute evidence that delivery of even the most basic public services is beyond the capacity of many local authorities in Indonesia.

Poor nutrition is another cause of child illness and death. The Asian Development Bank estimates that 28 percent of children below five years of age were under weight in 2005, up from 25 percent in 2000.[28] Malnutrition is a result of low incomes and inadequate education. Micronutrient deficiencies are also endemic in Indonesia.

Table 11. Rural households' access to improved water sources and sanitation

	Access to improved drinking water (%)			Access to improved sanitation (%)		
	1990	2000	2006	1990	2000	2006
Indonesia	**63**	**68**	**71**	**42**	**39**	**37**
Brazil	54	57	58	37	37	37
China	55	71	81	43	53	59
India	65	77	86	4	13	18
Malaysia	96	96	96	--	93	93
Philippines	75	84	88	46	64	72
Thailand	94	96	97	72	92	96
Viet Nam	43	72	90	21	43	56

Source: World Health Organization, http://apps.who.int/whosis/data/

[28]http://www.adb.org/documents/brochures/social-protection-project-briefs/ino-nutrition.pdf, accessed December 6, 2009.

Table 12. Causes of death of children under five, selected countries, 2000 (%)

	Diarrheal diseases	Measles
Indonesia	18.3	4.7
Brazil	12.0	0
China	11.8	0.4
India	20.3	3.7
Malaysia	5.4	0.9
Philippines	12.0	1.2
Thailand	16.2	0.1
Viet Nam	10.4	3.4

Source: World Health Organization, http://apps.who.int/whosis/data/

UNICEF estimates that up to forty percent of pregnant women and half of pre-school children suffer from iron deficiency anemia. IDA is responsible for one fourth of maternal deaths. Vitamin A and iodine deficiencies are common.

Maternal mortality is also high in Indonesia in comparison with other middle income countries in the region. At 420 deaths per 10,000 live births, mothers in Indonesia are nearly three times more likely to die in childbirth than Vietnamese mothers (Table 13). The problem is particularly acute in remote areas, but maternal death is also high in densely populated provinces like West Java that contain major urban centers. Complications during childbirth in the absence of skilled healthcare personnel account for more maternal deaths. As shown in the table, one third of births in Indonesia are still unattended. But even when skilled personnel are available, facilities are often unhygienic and blood supplies are unavailable for cases in which transfusions are required.

Poor mothers and children are most at risk from disease and early death. Table 14 presents basic indicators for child and maternal health by income quintile. A child from a household in the bottom income quintile is more than three times likely to die before his or her first birthday than a child from the top income quintile. He or she is 3.5

Table 13. Maternal mortality indicators, selected countries

	Births attended by skilled healthcare personnel		Maternal mortality per 10,000 live births
	Survey year	%	2005
Indonesia	**2003**	**66**	**420**
Brazil	2004	97	110
China	2006	98	45
India	2006	47	450
Malaysia	2005	100	62
Philippines	2003	60	230
Thailand	2006	97	110
Viet Nam	2006	88	150

Source: World Health Organization, http://apps.who.int/whosis/data/

Table 14. Health indicators by income quintile

	Wealth quintiles					
	1	2	3	4	5	Avg.
Infant mortality rate	60.6	50.3	44	36.4	17.1	43
Under-five mortality rate	76.8	64.4	55.7	45.1	21.9	54.4
Vaccinations						
BCG coverage	69.9	75.9	82.9	89	96.5	82.5
Measles coverage	59.5	64.8	71.7	78.9	84.9	71.6
DPT coverage	41.8	50.9	63.5	65.3	72.3	58.3
Full basic coverage	37.1	46.6	52.5	58.1	64.7	51.4
No basic coverage	20	13.5	6.2	7.3	1.8	10.1
Deliveries						
Attended by a medically trained person	39.9	56.1	68.7	80.6	93.6	66.2
Attended by a doctor	0.7	0.7	1	0.5	0.8	0.8
Attended by a nurse or trained midwife	39.1	55.3	67.7	80.1	92.8	65.5
In a public facility	3.6	7.9	9.9	11.8	14.7	9.2
In a private facility	7.3	16.8	28	41.7	66.6	30.5
At home	87.5	73.9	60.9	45.7	17.9	59

Source: Gwatkin et. al 2007

times more likely to die before his or her fifth birthday. Inequalities on this scale underscore the great gulf that continues to exist between well-off Indonesians and the poor.

At 1.1 percent of GDP, Indonesia spends less on public health than any country in the region. The government covers only one-third of total health expenditures, which is the lowest in the region. Investment in essential infrastructure has been inadequate to ensure people access to clean water, particularly in rural areas. The result is high levels of infant, child and maternal mortality for the country's level of income. It is hard to think of government functions that are more essential than these. Transforming Indonesia's institutions must begin with a reprioritization of basic public responsibilities and standards of performance to achieve real improvements in the life prospects of the country's most vulnerable citizens.

Box 2. Stealing from the Sick

The United Nations estimates that there were 270,000 people in Indonesia living with HIV in 2007, nearly three times the number in 2001. While fewer than 100 Indonesians died from AIDS related causes in 2001, 8,700 deaths were reported in 2007. Indonesia is experiencing a generalized HIV/AIDS epidemic. Although initially concentrated among injecting drug users and female sex workers, HIV is now increasingly prevalent among lower risk segments of the population (UNAIDS 2008).

Aid donors like the Global Fund to Fight AIDS, Tuberculosis and Malaria finance free antiretroviral (ARV) treatment in Indonesia including blood tests. However, only about ten percent of people living with HIV have access to ARVs. Patients are charged high prices for pills and blood tests, even at specially designated hospitals. Supply is irregular, which reduces the impact of the treatment and can even be counterproductive as sporadic administration of the drug increases resistance (Buehler 2009b, 22).

In a recent article in *Inside Indonesia*, Michael Buehler tells the story of Nuraini, an HIV-positive woman living in Jakarta. In her search for ARVs, she suffers a shocking ordeal at the hands of the Indonesian health system. She is given the wrong drugs, or given prescriptions for expensive drugs that are unrelated to her condition. She is forced to pay bribes to hospital staff to get pills. The supply of medicine is often interrupted. Callous doctors disappear without notice and leave her without the necessary signatures to obtain medicine. Hospitals lose blood tests and force her to wait for hours for service. She is even given pill boxes filled with dead ants (Buehler 2008).

Contrast the situation in Indonesia to that in Brazil, which has run an effective program to deliver free access to ARVs to all HIV positive patients since 1996. Mother-to-child transmission of HIV, AIDS-related hospitalization and mortality have all declined since then. Life expectancy of AIDS patients has more than tripled (Nunn et al. 2007).

Rising Inequality

Despite the countries poor record in meeting people's basic needs, many donor organizations and scholars still consider Indonesia to be a "pro-poor growth" success story. The New Order regime used oil revenues to invest in irrigation, rural roads, schools and clinics. These investments, combined with rice price stabilization, subsidized fertilizers and agricultural extension, created millions of jobs and increased small farmers' incomes over a period of three decades. Later, policies created an environment in which labor intensive manufactures could flourish. Rapid economic growth was accompanied by sharply falling poverty rates and remarkably stable and equitable patterns of income distribution (Timmer 2007; World Bank 2005; Cameron 2002). As shown in Figure 9, official statistics report nearly constant levels of income inequality (as measured by the Gini ratio) and a trend decline in poverty with the exception of the years immediately following the economic crisis of 1997-1998.[29] Moreover, Indonesia's performance with regards to poverty reduction and inequality compares favorably with other countries in the region (Table 15). With an official head-count poverty rate of 15 percent and low levels of inequality, Indonesia is frequently held up as a model of equitable development for other densely populated, lower middle income countries.[30]

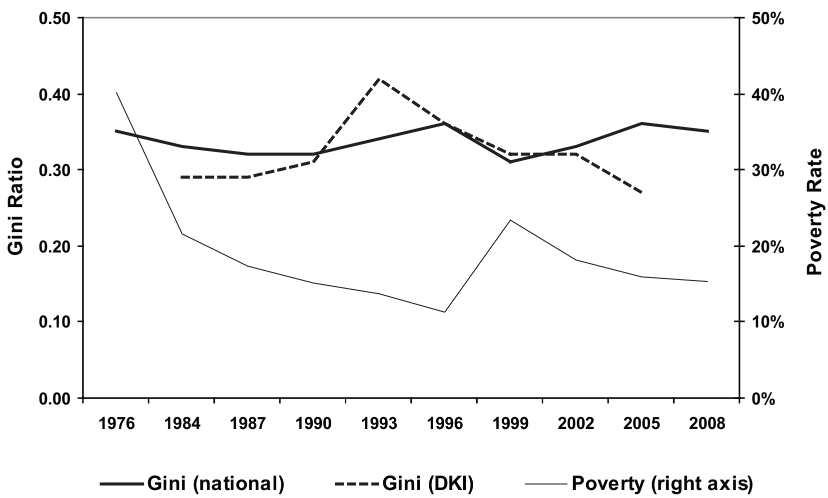
However, the figures that are routinely cited to back up these claims are not without problems. Poverty and inequality in Indonesia are usually measured on the basis of data from the various rounds of the National Socio-Economic Surveys (SUSENAS). The SUSENAS is a "nationally representative" expenditure survey conducted by the Badan Pusat Statistik (formerly the Biro Pusat Statistik). As in many countries, aggregate household consumption estimated from expenditure surveys is considerably lower than consumption derived from national accounts statistics. SUSENAS tends to undercount expenditures by high income households for a number of reasons. First, the very rich are a small group but they account for a significant share of national consumption. If they are under-represented in the sample, or if the richest households systematically absent themselves from the

[29]The Gini ratio is measure of income inequality, in which zero is complete equality (every individual or household has exactly the same share of national income) and one is complete inequality (one individual or household control all of national income).

[30]The World Bank has repeatedly singled out Indonesia's achievements in poverty reduction. In the words of one report, "[A]bsolute poverty [has] dropped from around 70 million (60 percent of the population) at the beginning of the 1970s to near 27 million by 1990 (about 15 percent)." This is the fastest rate of decline in poverty in any country" (Thomas and Stephens 1994, 9). The Bank is eager to point out its "supportive and vital role, providing timely and relevant economic advice and substantial financing for Indonesia's public investment program in education, health, agriculture, and infrastructure" (*Ibid*., 11). The Bank's rhetoric has remained remarkably consistent even in the *reformasi* era. Take, for example, a 2006 poverty assessment, which repeats the 1994 conclusion almost verbatim: "The period from the late 1970s to the mid-1990s is considered one of the most 'pro-poor growth' episodes in the economic history of any country" (World Bank 2006, v). Note also the similarity to World Bank Country Director Ajay Chibber's comments about Vietnam in 2008: "Over the past 15 years, Vietnam has achieved one of the world's fastest declines in poverty. The country's poverty rate…has declined from about 58 percent in 1993 to 16 percent in 2006, and 34 million people have come out of poverty" (Chibber 2008).

survey because of non-response, then SUSENAS results will understate inequality. Similarly, the non-food items listed in the survey do not capture a significant proportion of spending by the rich (for example, automobiles, international travel, overseas education and health care).

Figure 10. Poverty and inequality, 1976-2008



Source: Badan Pusat Statistik

Table 15. Poverty and inequality in Southeast Asia

	% population below national poverty line	Gini ratio
Indonesia (2008)	15.4%	0.35
Malaysia (2007)	3.6%	0.38
Philippines (2006)	32.9%	0.44
Thailand (2006)	9.6%	0.43
Vietnam (2006)	16.0%	0.38

Source: ADB 2009 and UNDP 2009

As shown in Table 16, the problem appears to be growing worse over time. In the last SUSENAS round, private consumption accounts for just 35 percent of the amount estimated from the national accounts. Not all of this extra consumption can be attributed to the rich, and national accounts data may overstate private consumption if other expenditure categories (for example investment or the trade surplus) are under-estimated. Smuggling and unrecorded investment account for some of the gap. Nevertheless, the tremendous divergence between the SUSENAS and national accounts estimates of consumption expenditure must mean that we need to interpret Indonesia's inequality estimates with caution. Yet none of the organizations that have routinely celebrated the country's pro-poor growth model have seen fit to mention these doubts in their glossy reports.

Table 16. Private consumption in SUSENAS and national accounts, 1969-2008

Year	SUSENAS (A)	National Accounts (B)	A/B
1969/70	1,949	2,428	0.80
1976	7,223	10,500	0.69
1978	9,488	15,126	0.63
1980	14,814	25,595	0.58
1984	30,674	54,066	0.57
1987	44,617	71,788	0.62
1990	64,721	106,312	0.61
1993	98,015	175,078	0.56
1996	165,810	332,094	0.50
1999	337,778	813,183	0.42
2002	525,683	1,231,965	0.43
2005	754,278	1,785,596	0.42
2008	1,066,381	3,019,459	0.35

Source: Mishra 2007; Badan Pusat Statistik 2008; and Statistical Yearbooks, various years.

Another reason to doubt the conventional wisdom is the mounting evidence that the concentration of wealth in Indonesia has proceeded at an historically rapid pace over this period. According to

Forbes magazine, the combined wealth of the forty richest Indonesians was $42 billion in 2009, or about eight percent of GDP (Nam 2009). These fortunes were amassed during the period covered by Indonesia's remarkably stable Gini coefficients. The businesses of the wealthiest Indonesians are concentrated in natural resource exploitation, finance and domestic consumer goods. At the other end of the distribution, the number of street children rose from 36,000 in 1997 to more than 230,000 in 2009 according to the Ministry of Social Affairs.[31]

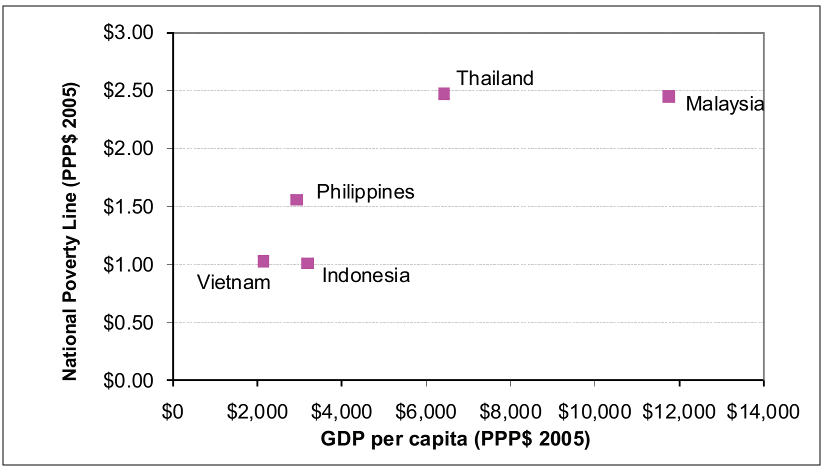
Even if we move beyond the super-rich and their likely absence from the SUSENAS coverage, there are still clear indications of poor statistical coverage. In 2007 there were about 52 million households and SUSENAS reported that 5.3 percent owned a car, implying a national total of 2.8 million cars. However, car registration data shows 8.4 million. Even if one adjusted for official and office cars and multiple car ownership by a very small share of households, it is likely that the upper income groups that had a car were undercounted by at least half. This is particularly important since car ownership is not sensitive or subtle—car ownership is easily detected. Ownership of motorcycles is also underestimated, though only by forty to fifty percent. Since the top tenth of households accounted for 32 percent of income in the official data (and this is likely an underestimate), if we doubled this group income distribution would be much worse. A rough estimate would put the Gini ratio at around 0.45, close to the 2004 estimate for China. It would also bring the ratio of SUSENAS to national income consumption back to more reasonable levels of about 60 percent. In short, the actual income distribution in Indonesia is much worse than official estimates based on the SUSENAS.

There are other reasons to believe that the accuracy of SUSENAS may be decreasing. Leigh and Van der Eng (2009) use income data from SUSENAS to calculate the income share of the top one percent of earners. It should be noted that the SUSENAS income module has

[31]"Akarnya Kemiskinan dan Rendahnya Prioritas [The Roots of Poverty and the Low Priority Attached to It]," *Kompas*, February 1, 2010, p. 1.

not been widely used because of doubts about the accuracy of reported incomes. Moreover, SUSENAS records only employees' income, in other words income from self-employment and returns to investment are not included. Nevertheless, the authors find that until 2001 the income of the top one percent of employees was high and rising: from seven percent of total income in 1982 to 15.5 percent in 2001. This is consistent with the rise of highly paid service jobs in finance and related sectors from the late 1980s. Yet in 2004, the share of the richest employees inexplicably drops to 8.5 percent. The most likely explanation is a combination of under-reporting and sampling bias resulting from non-response among upper income households.

Figure 11. International comparison of poverty lines



Source: ADB 2008

Indonesia's low headcount poverty rates are also partly a statistical artifact. Indonesia's official poverty line is among the lowest in the region—even lower than Vietnam's despite the fact that Indonesia's per capita income is still considerably higher. In 2005, Indonesia's poverty line was set at about $1 per person using the World Bank's purchasing power parity (PPP) exchange rates.[32] Thailand's poverty line was about $2.50 and the Philippines $1.60. Using such an extremely low threshold, Indonesia's headcount poverty rate presents an optimistic view of the actual poverty situation. Indeed, since a large share of the population is grouped within one standard deviation of the poverty line, small movements in the line result in large changes in poverty estimates. For example, Dhanani, Islam and Chowdhury, using 2002 SUSENAS data, find that an increase in the poverty line of about 25 percent results in an increase in the headcount rate of poverty from 18 to 53 percent (2009, 126).

It is not only that the poverty line is set very low. It is also likely that many of the poorest, who tend to be migrant workers or people living in slums, are not counted at all. The household sampling frame does not normally include temporary workers who do not have residence status in the village or city they work in. People who live in substandard or institutional housing—for example people living under bridges and workers living in company-provided dormitories—are also undercounted. It is difficult to adjust the available statistics for these gaps in coverage. More research is needed to arrive at a more accurate estimate of "missing migrants" and slum dwellers. But if the statistics are corrected for the low official poverty line and probable poor coverage of migrant groups, it is certain that the poverty rate in Indonesia would be much higher and probably well over half of the population would be classified as poor. This is consistent with the malnutrition data for children, which indicates that half to two-thirds of children suffer from inadequate diets. The policy implication is that much more remains to be done to move Indonesians beyond a very low level of living.

[32]Purchasing power parity (PPP) exchange rates between two countries adjust market exchange rates to reflect the relative cost of living in both places. The World Bank's International Comparison Program calculates PPP exchange rates for more than one hundred countries.

Box 3. Social Protection in Indonesia

The National Social Insurance System Law of 2004 guarantees social protection coverage to all Indonesian citizens. However, social protection policy in Indonesia still consists of a complicated patchwork of programs and pilot programs with impact limited by overlapping coverage and mixed objectives. Responsibility for the design of the system is shared among various agencies, each of which pursues its own institutional interests and adheres to its own analytical and procedural assumptions. The result is a complex, fragmented system that is long on ambition but short on impact.

Although overall responsibility for planning lies with the planning ministry (BAPPENAS), these plans do not carry much weight within the government as funding decisions are made in the Ministry of Finance independently of BAPPENAS. Program implementation is the responsibility of the Ministry of Social Welfare and the National Social Security Council, both of which lack the administrative structures and capacity to manage the programs in their respective portfolios. Moreover, both agencies must work through local authorities, many of which have obstructed rather than facilitated program implementation.

The various programs that comprise the system can be divided roughly into the categories of anti-poverty and social insurance programs, although there is considerable overlap between the two. Social insurance programs include Jamsostek, a state-owned provider of pensions and health, maternity, life and accident insurance to formal sector workers, mostly in the public sector, and Askes, a provider of health insurance to civil servants. Coverage of these programs is limited and they have been plagued by scandal and mismanagement. Jamkesmas (social health insurance) was launched in 2008 and according to the government the program covers 38 percent of the population (including social insurance provided by local authorities).[33] However, medi-

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[33]"Menuju Jaminan Kesehatan Sosial Nasional," *Kompas*, March 10, 2010,

cal practitioners claim that payments are too low to cover costs and that the program has not succeeded in targeting the poor.[34]

Numerous anti-poverty programs have been attempted over the years, including some emergency assistance measures in the wake of the 1997-1998 financial crisis. Ten years on, the government has focused its efforts on a combination of area development programs for poor localities and conditional cash transfers to poor households. The National Community Empowerment Program—the heir to the World Bank's Kecamatan Development Program—provides block grants to poor sub-districts to build infrastructure on make other investments. The problem with these initiatives is that they are based on the assumption that "poor communities" are socially homogenous (and therefore have easily identified investment priorities) and static, in the sense that people do not leave and new people are not arriving in large numbers. Most poor people in Indonesia do not live in localities in which these assumptions hold. The Program Keluarga Harapan ("Family Hope") Program is a pilot conditional cash transfer program that provides women with cash if they access child health and education services. Administrative complexity, inadequate provision of basic services, poor coordination between the program and service providers and ineffective targeting have hampered implementation (Dinar Dana Kharisma 2008).

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http://kesehatan.kompas.com/read/2010/03/25/09311811/Menuju.Jaminan.Kesehatan.Sosial.Nasional (accessed March 12, 2010).

[34]"Pemerintah Harus Perkuat Asuransi Kesehatan," *Bisnis Indonesia*, April 6, 2010, http://web.bisnis.com/senggang/kesehatan/1id173206.html (accessed April 7, 2010).

3. Constraints on Economic Progress

The challenge of global capitalism in the twenty-first century is to combine international integration with politically responsive, socially responsible government. Contemporary ideologues of many stripes—pro and anti-globalization, progressives and conservatives, marketeers and pamphleteers—argue that this combination is impossible or undesirable. But theory and history indicate that it is possible for globalization to coexist with policies committed to social advance. It remains for governments and people to put the possible into practice.

Jeffrey Frieden

In a changing world, all countries—industrialized, developing and everything in between—must run faster just to keep up with the competition. Rapid technological change forces firms to update products and production processes if they are to hold on to market share at home and abroad. The falling cost of communications, transportation and calculation strips away older forms of "natural protection" and opens domestic markets to international competition in the production of services as well as goods. Modularization and digitization of production has rendered the old international division of labor obsolete. Yet even as they open up to international markets, developing countries must construct social safety nets to protect the population from the risks of illness, old age and job loss. The growing wage premium on knowledge and skills has increased demand for higher education, and successful companies in Asia are scrambling to attract the best talent. But universities around the globe have found that they if do not adapt to globalization they will lose their best students and faculty to competitors at home and abroad, and thus lose touch with the global knowledge frontier.

Governments are under increasing pressure to create an environment conducive to growth and innovation. They must improve essential infrastructure and invest in health, education and social safety nets, while at the same time keeping tight control over spending to maintain macroeconomic stability. Regulation of financial markets must discourage excessive risk taking without creating unnecessary obstacles to business formation and development. Governments must prepare for the new energy economy of the 21st century and reduce pollution without imposing costs on businesses and households that reduce national competitiveness.

The central question is no longer (and perhaps never was) how big the government should be relative to the private sector, but instead the capacity of public institutions to achieve clearly defined and realistic objectives. A major challenge facing governments around the world is to identify those functions that the public sector must perform, and to resist political pressure to intervene in the economy in unproductive ways on behalf of powerful special interests. Intelligent deregulation and strategic divestment of under-performing state-owned enterprises are useful policy tools. Yet Indonesia's own experiments with deregulation show that *less* government is not always a remedy for *weak* government (Pincus and Ramli 1998). Getting the balance right, and improving the state's capacity to regulate fairly and provide essential services, is the key to unlocking the nation's economic potential.

The main point of this section is that the balance is not right in Indonesia. Government intervenes when it should not, and fails to act to provide public goods and redress clear cases of market failure. Over-regulation inhibits new businesses and firm growth, but investment in education and health is among the lowest in the region. Government institutions lack the capacity to resist political pressure and to implement policies in a transparent and accountable manner. In making this case, we address a range of key policy issues; however no attempt has been made to compile an exhaustive list of constraints on economic performance. We have selected the issues addressed below to capture the central importance of transforming public institutions to improving Indonesia's economic and social prospects.

Over-Reliance on Natural Resource Exploitation

Indonesia covers nearly two million square kilometers in land area and is blessed with an abundance of natural wealth. But since it is also a populous country, the per capita resource endowment is lower than neighboring Malaysia. On its own, natural resource exploitation will not be sufficient to bring Indonesia to upper middle income status.

China's growth presents natural resource exporters like Indonesia with tremendous opportunities to earn foreign exchange, create millions of jobs and develop profitable businesses. But natural resource exploitation must be sustainable. During the New Order, Indonesia squandered its natural heritage. Some oil money was invested in agriculture and infrastructure, but too much of it was wasted. The forests were largely destroyed and the profits privatized. At the beginning of the *reformasi* era there were hopes that democracy and openness would lead to more responsible management of natural resources, but this key objective has not yet been attained.

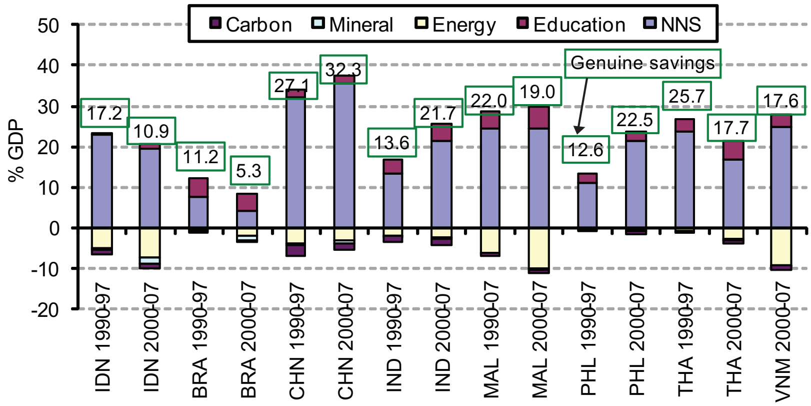
A good rule of thumb for natural resource intensive economies is that every dollar of natural resource rents that is extracted must be balanced by one dollar of investment in physical or human capital. If the country is depleting its natural resources faster than it is sustainably investing the proceeds, then the real national savings rate—or its "genuine savings"—will fall. In other words, a low genuine savings rate means that the country is consuming the proceeds of its resource endowment and leaving less for future generations.

A rough estimate of genuine savings rates as estimated by the World Bank is presented in Figure 12. The World Bank calculation starts with the net national savings rate, in other words national savings adjusted for the depreciation of the economy's fixed capital (shown as the blue bars in the figure). The World Bank then adds public spending on education, which represents the accumulation of human capital. As shown in the graphic, Indonesia's savings rates have never been particularly high and they have fallen in the *reformasi* era. Moreover, public spending on education is among the lowest in the region.

To obtain genuine savings, the World Bank then subtracts natural resource depletion. Unfortunately, the World Bank has not attempted to value the loss of forests in Indonesia, which is one of the most important causes of dis-saving. Nevertheless, we still have data for three relevant forms of natural resource depletion: energy, minerals and carbon. The value of energy and mineral depletion is measured in terms of the reduction in national reserves, and the cost of carbon emission is valued at US$20 per ton. Depletion is depicted as negative increments in the figure, with genuine savings reported in the green boxes. The crisis years of 1998 and 1999 have been omitted because of unusually low savings rates in these years across East and Southeast Asia.

As shown in the figure, Indonesia's genuine savings are the lowest in the region, even lower than the Philippines and Vietnam, despite the fact that the effects of deforestation are excluded. Only Brazil in our sample performed worse, although public investment in education was higher and energy and mineral depletion lower in Brazil. In short, Indonesia is consuming the nation's natural resource wealth and has little to show for it. Over the long period, a low rate of genuine savings will result in slow growth as the country runs out of resources but lacks the physical and human capital to engage in other value-generating activities.

Figure 12. Adjusted national savings (excluding deforestation)



Source: World Development Indicators

It is important to remember that the World Bank's genuine savings calculations do not yet include deforestation. If forest depletion were to be added to the total, the results would be even worse. Indonesia has destroyed its primary forests at an alarming rate. Deforestation began in earnest in the first half decade of the New Order, when nearly two-thirds of Kalimantan's land area was given over to industrial forestry. Although protected areas were set aside in the 1980s, poor monitoring and enforcement have resulted in continued logging, conversion and fires in these areas. Curran and co-authors estimate that from 1985 to 2001, lowland protected forest area in West Kalimantan province was reduced by 63 percent. The corresponding figure for the other provinces of Kalimantan was 52 percent (2004, 1002).

For the period 1990 to 2005, Hansen et al. have estimated forest depletion using remote sensing techniques. These results are shown in Table 17. Indonesia lost one-third of its lowland forests in this period. More than fifteen million hectares of lowland forest were cleared in Kalimantan and Sumatra. If, as a rough guide, lowland forest is valued at $10,000 per hectare, the loss to Indonesia from deforestation in Kalimantan and Sumatra would be equal to $150 billion, wiping out one third of Indonesia's already low genuine savings for the period 1990-2007.

Table 17. Forest depletion, 1990-2005

	Total forest cleared 1990–2005 in Mha	1990–2005 total % forest cleared	2005 forest cover in Mha
Indonesia	21.32	17.56	100.08
Lowlands	17.35	33.48	34.47
Uplands	3.97	5.71	65.62
Sumatra and Kalimantan	16.2	23.51	52.69
Lowlands	15.25	41.72	21.3
Uplands	0.95	2.94	31.39
Other	5.12	9.75	47.39
Lowlands	2.1	13.76	13.17
Uplands	3.02	8.11	34.23

Source: Hansen et al., 2009

Curran *et al.* (2004) report that forest depletion in Kalimantan's protected areas is not due to smallholder agriculture as is often maintained by Indonesia's timber industry. Population density is low and population growth is less than two percent per annum. Logging is the main cause. As timber concessions granted in the 1960s and 1970s were exhausted in the 1980s and 1990s, loggers moved into protected area. Nearly four-fifths of the eighteen concession operations surveyed by Curran and associates from 1999 to 2001 either directly harvested or received timber from protected areas. Logging activity is present in all protected areas surveyed.

Although control was weak under central administration, decentralization has accelerated forest depletion. District government can now issue small logging parcel leases, which has resulted in uncontrolled logging in the remaining accessible lowlands. Another cause of rapid deforestation is the expansion of oil palm estates, which increased from 100,000 hectares in the late 1960s to 2.5 million hectares by 1997. The spread of oil palm is also related to human-induced forest fires, which according to the government claimed some ten million hectares of forest in 1997 to 1998 alone (BAPPENAS and ADB 1999). Palm-oil plantations used adverse weather conditions of the El-Niño drought as a cover to set fires and extend plantations into protected areas (Hansen *et al.*, 2009).

The Forestry Ministry claims jurisdiction over more than 70 percent of Indonesia's total land mass. Much like the United States in the 19th century, Indonesia is engaged in an extended process of primitive capital accumulation through the exploitation of vast tracts of public land. The argument is often made that privatizing land rights would solve the deforestation problem, but this assumes that private actors have sufficiently long time horizons to prefer sustainable forest management over short term gain. The evidence suggests otherwise.

Deforestation is also a major source of carbon emissions. The National Council on Climate Change estimates that in 2005 Indonesia was responsible for emissions of 2.3 gigatons of carbon, among the largest in the world. Forestry and degradation and fires on peat land account for more than 80 percent of the country's emissions. Emissions from Indonesia's peat lands are currently more than the global airline industry. Peat land degrades or burns after forests are cut and peat that has formed over thousands of years dries out. Indonesia, which has five percent of the world's peat land area, is deforesting peat faster than any other country in the world.

Another way in which Indonesia remains overly dependent on natural resources is the failure to develop processing industries to capitalize on the natural cost advantages made available by the domestic production of ores. Tables 18 and 19 provide an indication of Indonesia's over-reliance on the export of raw ores in comparison with other major world producers. The tables report average exports of raw ores and concentrates and metal for two of Indonesia's most important mineral exports, copper and nickel. In value terms, Indonesia exports of ores and concentrates was nearly twice as great as copper exports over the period 2006-2008. The situation is even more striking for nickel: over the same period Indonesia exported 66 times as more raw nickel ore and concentrates as metal.

Table 18. Value of copper ore and copper exports, USD millions

	Copper ores, concentrates (A)	Copper (B)	(A/B)
Australia	3,222	2,622	1.23
Canada	1,682	3,762	0.45
Chile	12,739	22,801	0.56
China	2.67	4,983	0.00
Indonesia	4,067	2,100	1.94
Peru	4,123	3,208	1.29

Average exports in US dollars, 2006-2008

Source: UN Comtrade

Table 19. Value of nickel ore and nickel exports, USD millions

	Nickel ores, concentrates (A)	Nickel (B)	(A/B)
Australia	1,231	760	1.62
Canada	3,476	4,030	0.86
Indonesia	2,100	31.8	66.18
Russian Federation	64.8	6,733	0.01

Average exports in US dollars, 2006-2008

Source: UN Comtrade

Box 4. Indonesia's Greenhouse Gas Emissions

Indonesia has moved near the top of the table in one international ranking: emission of green house gases. Forest destruction in Indonesia is the fastest in the world, which is the main factor in lifting the country to third place behind the United States and China in carbon emissions. Peat, formed over thousands of years from the trees and plants of the forest, is a major source of carbon emissions. After the trees are cut down, peat forests dry and burn, releasing carbon dioxide into the atmosphere. According to Wetlands International, in 2006 Indonesia's peat lands released as much carbon dioxide as Germany, the UK and Canada combined (Higgins 2009).

At the Global Climate Change Conference in Copenhagen in December 2009 President Yudhoyono pledged Indonesia to a target of reducing green house gasses by 26 percent over the next ten years. He claimed that with overseas aid Indonesia could reduce emissions by 41 percent over the same period. One of the mechanisms that Indonesia hopes will deliver this aid is the proposed global initiative for Reducing Emissions from Deforestation and Forest Degradation (REDD+). Under this scheme, Indonesia would be paid to protect existing forest stands and rehabilitate degraded forests.

However, one of the main obstacles to implementing schemes like REDD+ in Indonesia is the poor quality of domestic institutions. A recent study by the Center for International Forestry Research (Barr *et al.* 2010) reviews the performance of the country's official Reforestation Fund under the New Order and *reformasi* governments. Over the twenty year period since the Reforestation Fund was established in 1989, it collected $5.8 billion from timber concessionaires. During the Suharto period the fund was managed by the Ministry of Forestry, and for the most part diverted to politically well-connected businesses. The fund was moved to the Ministry of Finance as part of the IMF bail-out agreement in 1998. Under *reformasi*, corruption and misuse of the fund by local authorities has resulted in substantial losses, and the Ministry of Forestry is still approving schemes to fund commercial plantations from the Reforestation Fund that actually accelerate forest destruction.

Indonesia will not receive REDD+ funds on a substantial scale unless the government can transform its institutions at the central and local levels to achieve accountability and transparency in the implementation of forest protection and rehabilitation projects. This extends beyond the Ministry of Forestry to the Ministry of Finance, provincial and district authorities and government oversight and auditing agencies. Greater willingness to involve local communities and civil society groups will be essential if Indonesia is to improve its reputation sufficiently to make use of this potentially important source of international assistance.

Underinvestment in People

A country that relies on natural resources has less incentive to invest in its people, though some do. The skills needed for higher value-added manufacturing are less urgently required, so progress in health and education depends on political priorities. In Indonesia, there was a rise in literacy and enrollment rates in the New Order, though net secondary enrollment in 1991 was only 39 percent and the under-five mortality rate was still 91/1000 in 1990.[35] Since 2000, decentralization has devolved responsibility for many health and education programs to local government, where they are not always a priority. While enrollment levels have tended to increase, the quality of education has not. As discussed above, measures of health effort such as vaccination rates have also sometimes declined. Low quality education and poor preventative health efforts are consistent with very low shares spent on health and education compared to neighboring countries.

It is very difficult for a child to learn if he or she is sick or malnourished. Overall food intake measured in calories per capita have not changed much over the years, and average intake in the 2008 SUSENAS was still around 2000 calories per capita per day. This is consistent with a large number of families close to the poverty line. Recent nutrition surveys indicate that the prevalence of wasting (low weight for age) among children under-five was nearly one third and more than 36 percent of the age group was stunted (height for age).

[35]In 1990, under-five mortality rates were 31/1000 in Thailand, 53/1000 in Vietnam and 62/1000 in the Philippines.

So wasting or stunting affects two-thirds of Indonesian children under five years of age. Studies have shown that stunting in early childhood is associated with behavioral problems and lower test scores at age 11 to 12 regardless of social background (Chang *et al* 2002).

Malnourished children tend to get sick more often. That is why the decline in vaccination rates for one-year olds is especially disturbing. Vaccinations for measles, for example, covered over 90 percent of babies in the mid-1990s and recently covered only 72 percent. The collapse of the *posyandu* system has meant less identification or treatment of malnutrition or provision of standard preventative care.

It is not good to be sick and malnourished if you are trying to learn, but it is even worse if the teacher is unskilled and is often absent from school. Part of this is simply due to low salaries. Even relative to GDP per capita, Indonesian primary teachers earn only half as much as their counterparts in the Philippines or Thailand. The World Bank estimates that one in five teachers do not show up on any given day. Many of those who do are not trained to teach. While a law was passed in 2005 phasing in qualified teachers, in 2006 it was found that 82 percent of primary school teachers and one-third of junior secondary teachers did not have a college education. Given these drawbacks, it is not surprising that the quality of education as measured by various international tests finds Indonesia in the lower fifth of nations tested. For example, Indonesia placed 42 out of 45 nations in the International Reading Literacy Study and 50 out of 57 in scientific and mathematical literacy in the Program for International Student Assessment.

The troubles in education extend to Indonesia's colleges and universities. The New Order allowed a proliferation of private universities (400 in 1975 to 1450 in 1998), but many of them were of very low quality. Even those private programs with better trained professors often borrow them from public universities, furthering a tendency to "sing" the same song over and over again in different classrooms while abandoning research. Universities now have more autonomy than before, but they have tended to use it in perverse ways. There is now, even in top institutions, a two-tiered admissions system where some students are admitted on the basis of their scores on competitive tests and while others buy their places, sometimes paying thousands of dollars. (This is not tuition, but a separate charge simply to be admitted.) This devalues the degree and the institution, which can no longer claim that its primary objective is the pursuit of excellence.

It is not only that many colleges are of poor quality. They also do not teach enough of what the economy needs. Most private universities lack the resources to offer science programs because they cannot afford laboratories and special equipment. If the quality of all science programs is reflected in the number of internationally published articles per million people, Indonesia is lagging badly. In 2005, only 205 articles published in international journals came from Indonesia. This is less than one article per million people. Over two articles per million were published in the Philippines, nearly three per million in Vietnam and nearly twenty per million in Thailand. Lack of scientific quality and quantity carries over into very low expenditure for research and development (R&D). R&D spending amounted to only 0.05 percent of GDP in Indonesia, which is one third of the rate in the Philippines and a fifth of the Thai level. Low levels of investment in R&D translate into few patents applied for in Indonesia by Indonesians. There was only about one patent application per million Indonesians. Taken together, this means that borrowing or adapting technology to raise productivity will be difficult because there are so few people who are qualified to do it. Thus, as wages slowly rise in real terms, Indonesia will be vulnerable to losing its labor intensive jobs without being able to move up into more skill-intensive ones.

Real wages in manufacturing have not risen from 2002 to 2009 in Indonesia, a suggestion that productivity has failed to improve since real wages usually grow in tandem with output per worker. Since investment chases skills, it will be hard to justify higher real wages if the entire system of improving skills—starting with health and nutrition, moving on to primary and secondary school, and finally to universities—is not upgraded. Moves have already been made to increase funding for education, but this has to be followed up with steps to ensure proper use of increased funding and also supporting investments in health and nutrition programs. This amounts to a large and ambitious program that does not yet have the full support of leaders in Jakarta or at the district level. If natural resources are run down while human capital remains at a low level, even relative to its neighbors, Indonesia will have diminished its future.

An Overvalued Exchange Rate

Bank Indonesia (BI) has explicitly adopted inflation targeting as its monetary policy strategy. One of the lessons that BI drew from the experience of the 1997/98 crisis was that "impossible trilemma" really is impossible: in other words, the country could not pursue an independent monetary policy in the context of an open capital account and a pegged exchange rate. In view of the fact that successive governments (and indeed all of the major opposition parties in any given period) have remained committed to an open capital account, the choices open to BI are limited. The central bank uses interest rates to steer the economy towards a target rate of inflation while allowing the rupiah to find its level. The rationale of inflation targeting is that the adoption of a transparent monetary policy rule will anchor inflation and exchange rate expectations, resulting in less volatility and over-shooting in the markets. If current inflation is higher than the target level, the markets will expect interest rates to move up. Currency traders will also adjust their expectations accordingly. Abandoning the currency peg reduces incentives to build up unhedged currency mismatches, therefore making the risk of a repeat of the 1997 meltdown less likely.[36]

In practice, exchange rate movements in emerging economies with open capital markets are more likely to reflect short term capital move-

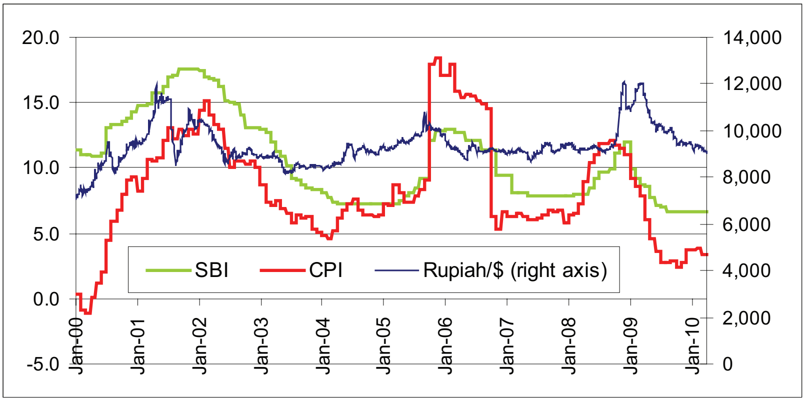
[36]See Obstfeld, Shambaugh and Taylor 2005 for a summary of the trilemma literature and it application to successive financial crises.

ments than medium term price expectations. BI has found that is has to continue to manage the nominal exchange rate to avoid destabilizing volatility in the exchange rate. As a result, the nominal rupiah-dollar exchange rate has fluctuated considerably less than inflation as measured by the consumer price index (CPI) (see Figure 13). Yet in real terms the rupiah has appreciated against the dollar and other currencies because price inflation has been more rapid in Indonesia than in the US and other industrialized countries. The rupiah's real effective exchange rate, which nets out inflation and applies country weights based on trade patterns, is now 30 percent higher than the period immediately prior to the 1997/98 financial crisis. Indonesia's real exchange rate has appreciated more than China's or any of Indonesia's main competitors in the region (Figure 14).

An overvalued exchange rate helps debtors, portfolio investors and importers, but penalizes exporters. It has helped the Indonesian government pay down its foreign debt and contributed to inflation control, but it has also delivered windfall gains to foreign buyers of Indonesian bonds, who have earned on average slightly more than 10 percent per annum in dollar terms. This has given rise to a large carry trade, in which investors borrow overseas at low rates of interest and buy Indonesian bonds. The resulting capital inflows further bolster the value of the rupiah. A similar dynamic has pushed up prices in the equity markets.

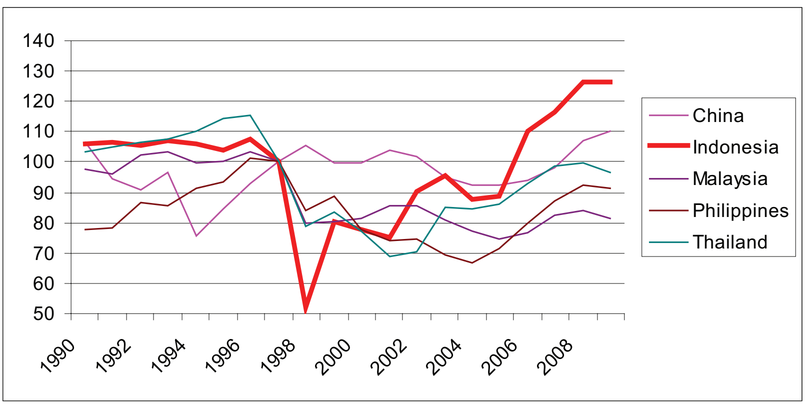
The costs and benefits of the strong rupiah policy have received remarkably little attention from Indonesian economists, reflecting the dominance of financial sector interests in domestic economic analysis. Pressure to reconsider this policy are likely to emerge in the context of the China-ASEAN Free Trade Area if tariff reductions combined with an overvalued exchange rate result in a surge of consumer goods imports over the coming year.

Figure 13. Interest rates, inflation and exchange rate 2000-2010



SBI a three month Bank Indonesia security.
Sources: Bank Indonesia and IMF.

Figure 14. Real Effective Exchange Rates 1990-2009 (1997=100)



Source: Economist Intelligence Unit

Squandered Fiscal Space

Indonesia has pursued extremely prudent fiscal policies over the past decade, containing public expenditure while dramatically increasing tax effort. It has therefore consistently run annual deficits of less than two percent of GDP, slashed the ratio of public debt to GDP from 80 percent in 2000 to 33 percent in 2008, and reduced annual interest payments as a share of national public expenditure from 25 percent in 2001 to nine percent in 2008.

A key component of these accomplishments has been the tax reform program initiated in 2006, entailing significant changes in both tax design and tax administration. The number of taxpayers tripled and tax revenue doubled from 2005 to 2008. National public expenditure to GDP is now 20 percent, which compares favorably to Indonesia's ASEAN neighbors and BRIC countries (except Brazil). The recent tax collection scandal, in which a mid-level tax official was discovered to have amassed over three million US dollars in side payments, revealed a deeply entrenched system to pilfer tax revenues involving tax officials, the police, prosecutors and judges.

The government has also failed to maximize revenue from natural resources. For example, the *Badan Pengawasan Keuangan dan Pembangunan* (Finance and Development Supervisory Body)—an auditing agency that reports to the president and vice-president—reported that six coal mining companies have failed to pay royalties of seven trillion rupiah (about $700 million) for more than one year. One of the companies is owned by the family of former Minister for Social Welfare Aburizal Bakrie (Jajang Sumantri 2010).

Government expenditures excluding interest payments, civil service salaries, and transfers to the regions were 51 percent of total central government spending in 2008. However, roughly half of this amount is now being spent on subsidies rather than investments in public infrastructure and services. Moreover, although interest payments have declined, the rising trend in both regional transfer and personnel expenditures threatens to erode Indonesia's discretionary spending potential: in 2008, 30 percent of the central budget was spent on transfers to the regions and 24 percent of total national spending was for personnel, most of this at the subnational level.

Indonesia faces numerous public finance challenges over the coming years. Control over personnel costs is needed to ensure that resources are available for public investment and essential services. Repeal of the provision that grants total regional government wage bill coverage from the *Dana Alokasi Umum* (DAU) basic allocation is an essential first step. Reduction of fuel and energy subsidies, discussed in earlier sections, is needed generate resources to invest in the power sector and to reduce the drain on government finances. Over the medium term, the system of intergovernmental transfers needs to be restructured to encourage mobilization of local resources. Administrative capacity is weak throughout the system, but the situation is most serious at the local level. District governments account for more than one third of public spending but are unable to fulfill even basic planning, reporting and control functions.

The License "Kerajaan"

Pre-reform India maintained a labyrinthine system of controls on private investment and business activity that was commonly known as the "License Raj." The intention was to carve the domestic market up for large public and private businesses, which would benefit from economies of scale and reinvest their massive profits to accelerate the rate of growth. It didn't work out that way. Because large profits accrued to license holders, business people channeled their efforts into getting government permits rather than creating value. Existing firms did not face much competition from new start-ups, so they did not need to innovate to increase efficiency. Economic growth was slow, and India wound up with a small number of large but inefficient and backward-looking firms. Liberalization was forced on India in 1991 when the country ran out of foreign exchange.

Indonesia has operated various forms of its own "license *kerajaan*" since the 1950s. The results are similar to those of pre-reform India. Indonesia has a small number of very large firms, very few middle-sized firms and an ocean of very small firms, most of which operate in the informal or non-enumerated sector. In manufacturing, a small number of firms dominate nearly every important market. Table 20 presents industrial concentration ratios for manufacturing industry calculated by Haryo Aswicahyono, Narjoko and Hill (2008). The authors find that in all sub-sectors the largest four firms dominate the market, ranging from 33 percent (wood and wood products) to 79 percent (other manufacturing). It is also interesting that concentration ratios are higher in the *reformasi* period than during the last decade of the New Order for most sub-sectors. In some cases, the largest companies are state-owned enterprises that are given trade protection and other privileges from government. But in many cases the firms in question are private corporations that benefit from government favors and an industrial structure that discourages new entries and therefore domestic competition.

Indonesia's industrial structure consists of a few massive conglomerates and millions of tiny firms. The "missing middle" phenomenon is a symptom of weak legal and regulatory institutions. Excessive and inconsistent regulation makes it more costly to open and operate businesses in Indonesia than in most major competitors. It is more costly to employ labor and enforce contracts. As a result, small firms remain rooted to the informal sector and do not get access to the financing they need to grow into larger companies.

Business registration in Indonesia is complex, time consuming and expensive. The Asia Foundation reports that the Ministry of Trade alone maintains a system of 122 different categories of business licenses. Decentralization has made the problem worse because district governments use registration and licensing as a means of revenue collection. The result is a proliferation of licenses and multiple licenses for each business activity. A majority of small firms remain unregistered largely as a result of the cost and complexity of licensing procedures. Businesses also report that they rely on middlemen to process license applications because they do not have the time satisfy all of the administrative requirements to obtain all of the permits that they need (Asia Foundation 2008a).

Table 20. Industrial concentration ratios, Indonesia

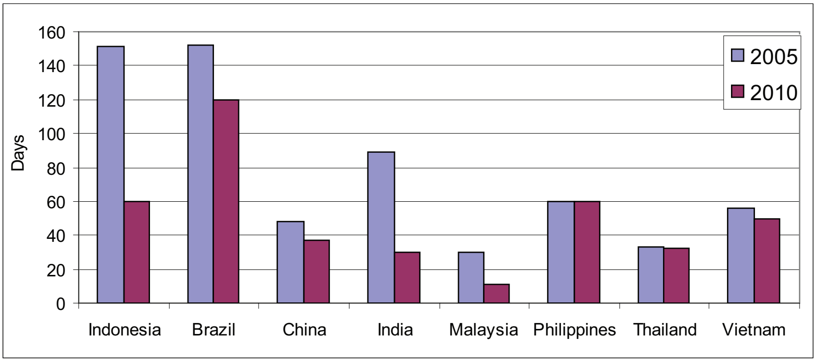
	1990	1996	2005
Food, beverages and tobacco	59	59	60
Textiles, clothes and leather	29	28	42
Wood and wood products	22	26	33
Paper and paper products	61	61	64
Chemicals and chemical products	58	57	57
Non-metallic mineral products	61	59	66
Basic metals industries	80	79	66
Fabricated metal, machinery	74	74	71
Other manufacturing	61	61	79
Unskilled labor intensive industries	30	29	43
Resource based, labor intensive industries	48	51	57
Resource based, capital intensive industries	65	64	61
Electronics	74	68	67
Footloose capital intensive	73	78	72

Concentration ratios defined as the share of the four largest firms in total output.
Source: Haryo Aswicahyono, Narjoko and Hill 2008

According to the World Bank, it takes sixty days to start a business in Indonesia (Figure 15). This represents a significant improvement over 2005, when the same procedures took 151 days. But other countries are changing faster. The time required to start a business in India fell from 89 to thirty days over the same period, and in Malaysia from thirty to eleven days. Only Brazil in our comparison group performs worse than Indonesia. A more positive sign is that Indonesia has reduced the cost of business registration from 130 percent of per capita income to 26 percent over the same five year period. Although still considerably higher than other countries in the group (except for India), this does represent real progress towards making legal registration more accessible to small businesses.

In addition to licenses, local governments also rely heavily on user charges, which place disproportionately large burden on smaller firms. Road user fees and other legal and illegal transport charges levied by local government, the police and even local mafia (*preman*) groups force up transport costs (Asia Foundation 2008b). Local user charges are generally unrelated to investment in infrastructure or improvements to services.

Figure 15. Number of days to start a business



Source: World Bank, 2009

Table 21. Investor Protection Indicators

	Indonesia	Brazil	China	India	Malaysia	Philippines	Thailand	Vietnam
Cost of enforcing contract (% of claim)	122.7	16.5	11.1	39.6	27.5	26	12.3	28.5
Strength of legal rights index	3	3	6	8	10	3	4	8
Ease of Shareholder suits index	3	3	4	7	7	8	6	2
Director liability index	5	7	1	4	9	2	7	0
Indices are based on composite rankings, with a score of 10 highest and 9 lowest. See World Bank 2009, p. 38-42 for details.								

Source: World Bank, 2009

Indonesia's legal system is another source of bias against small companies. Small businesses are vulnerable to predation by powerful people, companies and government agencies (Table 22). Only the Philippines performs as poorly as Indonesia in terms of legal protection. To make matters worse, enforcing claims in Indonesia is unaffordable. According to the World Bank, the cost of enforcing a claim is 1.2 times the value of the claim itself! This ratio is three times higher in Indonesia than in India and more than ten times higher than China. In other words, small businesses and individuals do not have access to the courts to protect themselves against the rich and powerful.

The high cost of formality is also evident in the cost of land registration fees. The World Bank reports that the cost of legal registration in Indonesia is nearly eleven percent of the value of the property (Figure 16). This is four times higher than Brazil and Malaysia and ten times higher than Thailand and Vietnam. The predictable response to unreasonably high registration costs is to remain unregistered or informal. Only twenty percent of privately held land is registered in Indonesia. The government has for many years attempted to accelerate land titling with support from the World Bank and other donors, most recently in the form of the World Bank Land Management and Policy Development Project, which ran from 2004 to 2009. However, under Indonesian law developers and government agencies are still able to claim land from owners—even owners with secure title—with little or no compensation. These laws have not been changed by successive *reformasi* governments. They represent a greater threat to land security than absence of legal title. Moreover, land titling programs have targeted less vulnerable land owners who possess traditional (*adat*) but not formal land rights, while excluding households squatting on public, and in some cases private, land. Household falling into the latter category are more numerous, particularly in cities, and more vulnerable to displacement without compensation (Reerink and Van Gelder 2010).

Figure 16. Cost of registering property as % of value

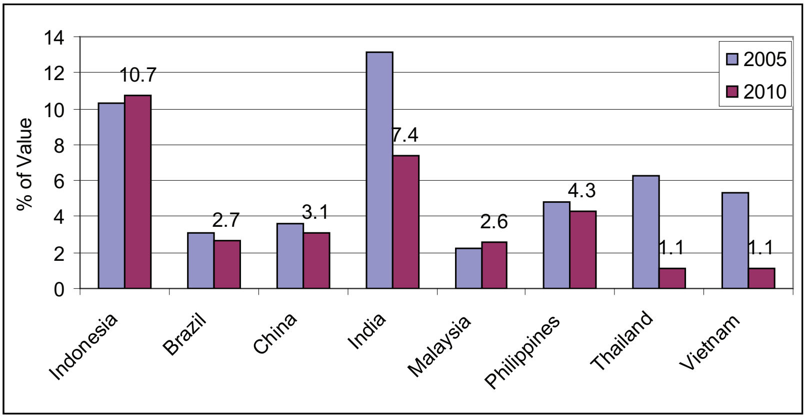


Table 22. Labor market rigidity indicators

	Indo-nesia	Brazil	China	India	Ma-laysia	Philip-pines	Thai-land	Viet-nam
Redundancy cost (weeks of salary)	108	46	91	56	75	91	54	87
Rigidity of redundancy index	60	0	50	70	30	30	0	40
Rigidity of hiring index	61	78	11	0	0	56	33	11
Rigidity of hours index	0	60	33	20	0	0	0	13

Source: World Bank 2009

We have already seen that overregulation of the labor market makes it more expensive to hire workers and therefore slows the rate of job creation.[37] Labor market rigidity is also an obstacle to formal registration of businesses. The main problem is the cost of redundancy, which, according to the World Bank, is the highest among our comparison group (Table 22). Indonesia also makes it more difficult for companies

[37]See page 17.

to hire workers by limiting the duration of fixed term contracts and specifying the kinds of task that employees on fixed term contracts can perform. This places companies in a double bind. Because redundancy costs are so high, firms are reluctant to hire permanent workers. Yet since the use of fixed-term contracts is also circumscribed, businesses may be unable to legally (formally) expand their operations in a cost-effective manner. This either forces them into the informal or underground economy, or discourages them from expanding their operations.

Inefficient State-Owned Enterprises

Many of Indonesia's state owned enterprises are a drag on the economy. As a recent article put it, "Indonesian state enterprises have been mismanaged and have served as breeding grounds for corruption, collusion and nepotism for decades. These vested interests are formidable obstacles to reform" (Yasmin Sungkar 2008, 109). Only a few companies make most of total SOE profits, and the other SOEs represent a drain on public budgets. They are a missed opportunity to create jobs and raise national productivity. Anyone who has travelled across Indonesia's rural areas has seen highly productive private plantations employing thousands of people existing side by side with poorly managed state-owned plantations in which land is lying idle except for the unplanned intrusion of neighboring villagers. The result is not just fewer jobs and less government revenue, but also soil erosion and deforestation. The situation is replicated across numerous sectors and firms.

The contribution of SOEs to the economy is small relative to the size of their assets. In 2007, SOEs contributed 8.5 percent of total exports, while the value of assets was equal to about 54 percent of GDP.[38] Meanwhile, their contribution to national revenue is about 5.3 per-

[38]If Indonesia's capital stock is three times GDP, then SOE capital is 18 percent of total capital.

cent and total SOE profits are about one percent of GDP. This implies a return of only two percent on assets, despite the protection from competition and other special advantages that some SOEs enjoy.

Almost 80 percent of assets are held in just six out of 139 SOEs, suggesting that most SOEs could be privatized without a major impact on the economy. In 2006, 88 percent of SOE profits were contributed by just ten companies. Figures for 2008, shown in Table 23, reveal that just two companies account for the bulk of SOE profits. Three state-owned banks (Bank Rakyat Indonesia, Bank Mandiri and Bank Negara Indonesia) also contribute significantly to government revenues. BRI recorded the largest profits among the state-owned banks, partly because of its efficient operation in micro banking with high interest rate spreads.

PT. Perusahaan Listrik Negara (National Electric Company) topped the list of money losing SOEs in 2008 (Table 24). The scale of annual losses at PLN is truly alarming, equivalent to approximately $1.2 billion in 2008. Merpati Airlines was another big money loser. Other companies not listed in the table that routinely record losses include PT. Krakatau Steel, PT Pelayaran Nasional, Perkapalan Kodja Bahari (shipping) and PT DOK (ship building and repair). State-owned plantations also perform poorly.

Table 23. Most profitable State-Owned Enterprises, 2008

	Companies	Profit value (in million Rp)
1	PT Pertamina	30,195,140
2	PT Telekomunikasi Indonesia, Tbk (TELKOM)	10,619,470
3	PT Bank Rakyat Indonesia, Tbk (BRI)	5,958,368
4	PT Bank Mandiri, Tbk	5,312,820
5	PT Semen Gresik, Tbk	2,523,544
6	PT Pupuk Sriwidjaja (PUSRI)	2,112,638
7	PT Timah, Tbk	1,342,351
8	PT Bank Negara Indonesia, Tbk (BNI)	1,222,485
9	PT Asuransi Kesehatan Indonesia (ASKES)	1,136,818
10	PT Jaminan Sosial Tenaga Kerja (JAMSOSTEK)	1,090,481

Source: Kiki Verico and A. Prasetyantoko 2009

Table 24. Biggest money losers among SOEs, 2008

	Companies	Loss value (in million Rp)
1	PT Perusahaan Listrik Negara (PLN)	-12,303,716
2	PT Merpati Nusantara Airlines (MNA)	-559,879
3	PT Kertas Kraft Aceh	-149,657
4	PT Djakarta Lloyd	-149,546
5	PT Perkebunan Nusantara XIV (PTPN XIV)	-108,402
6	PT Dirgantara Indonesia	-843,46
7	PT Kereta Api Indonesia (KAI)	-83,486
8	PT Industri Gelas (IGLAS)	-81,286
9	PT Industri Sandang Nusantara (INSAN)	-71,886
10	PT Pos Indonesia (POSINDO)	-57,905

Source: Kiki Verico and A. Prasetyantoko 2009

In 2008, plans were announced to privatize thirty SOEs including Krakatau Steel, Garuda Airlines and Bank Tabungan Negara. In total, the proceeds were expected to bring in nearly $1 billion, even though only about 30 percent of the ownership was to be sold. The hope was that public listing would result in better corporate governance and better performance. Except for the bank and one construction firm, these plans were put on hold, though Garuda and Krakatau may still be partly privatized later in 2010. There is resistance to selling shares when prices are low and performance is poor and a lack of pressure to sell if performance is good. Labor unions, local officials and many in the parliament oppose any privatization, leaving new initiatives vulnerable to events and populist pressures. As Yasmin Sungkar concludes, “Privatization has seldom gone to plan in Indonesia” (2008, 112).

The issue of how to improve the performance of SOEs and to increase their international competitiveness has sparked a long and vigorous debate in Indonesia. One idea is to create several strong SOEs so they can become competitive global firms. For example, the government intends to merge two state pharmaceutical companies—Kima Farma and Indofarma—in 2010 in the hopes of achieving synergies and economies of scale. However, corporate governance at these firms has been weak, and it is far from clear that making them bigger will result in better performance. The president-director of Kimia Farma faced charges in December 2009 of paying bribes to the Minister of Health for supply contracts. Another suggestion is to create holding companies, like Temasek in Singapore and Khazanah in Malaysia, to manage SOE assets. Holding companies could also be created to manage sectors, for example chemicals or shipping. But this could have the unintended effect of making it easier for companies to collude against private sector competitors, and would create a powerful lobby group within government for protection and favors.

China's approach after the East Asian financial crisis was to use competition and international institutional standards to force SOEs to compete. Although SOEs largely remained within the state sector, China's World Trade Organization agreement opened the domestic market to international companies. Domestic companies, whether state or private owned, had to learn how to compete in most sectors. In addition, SOEs sold shares on the Hong Kong and New York markets and as a result were forced to meet more rigorous accounting rules. Prominent international business leaders were also invited to join the boards of these companies as a signal to outsiders that they had accepted the international "rules of the game" (Steinfeld 2008).

It is clear that Indonesia needs much better performance from most of its SOEs, but the government will find it hard to improve outcomes simply by trying to shield companies from political interference. Political resistance to even partial privatization will be strong, so the question will be if the unsatisfactory status quo is maintained or if there is an effort to improve efficiency by changing governance through the use of private management. Concerns about unfair selling prices can be handled by fair auction procedures and reasonable timing of sales. If the state retains significant ownership shares, better operations should result in higher share prices and benefits to the government. In the end, privatization is a political decision, but it is more likely to inspire public support if it is carried out in a transparent manner.

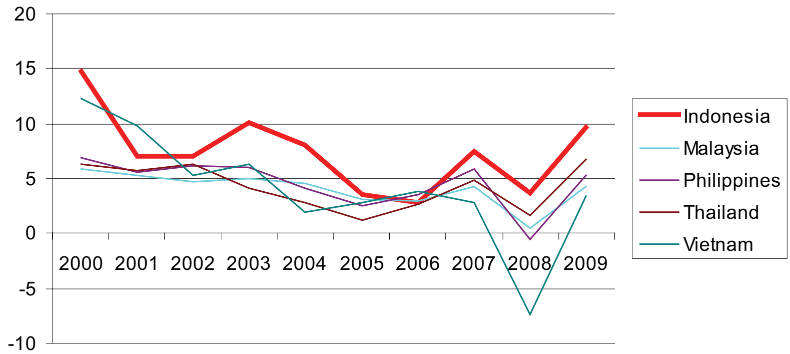
Costly Financial Exclusion

Indonesia's banking system has been through some tumultuous times over the past two decades, most notably the dramatic deregulation and liberalization of the mid-1980s. The absence of adequate regulation and supervisory capacity contributed to the implosion of the banking sector during the East Asian financial crisis a decade later. The number of banks fell from 239 in 1996 to 153 in 2000, and the resulting bailout is estimated to have cost 70 percent of 1999 GDP.

More than a decade later, the banking system is liquid and solvent. It has not been directly damaged by the current global economic crisis, the effect of which has been indirect and stem from the slowdown in the real economy. However, bank coverage is limited, bank efficiency is low, and regulation and supervision are weak, as demonstrated by the recent Bank Century case.

The banking sector dominates financial intermediation in Indonesia. Capital markets are still small relative to the size of the economy and commercial banks hold 79 percent of total financial sector assets. However, bank credit is still only 44 percent of GDP, quite small when compared with both ASEAN and BRIC countries. Moreover, roughly half of Indonesian households are estimated to lack access to formal financial services, even though banks are underleveraged at the moment, with a loan to deposit ratio at about 70 percent and loans making up just over half of total bank assets. There is also little competition within the banking sector to encourage entry into underserved markets and to spur the development of innovative products and delivery systems. The banking sector is dominated by a handful of banks, with four banks accounting for 44 percent of total bank assets. Deposits are also highly concentrated, with 0.1 percent of accounts totaling 46 percent of deposit value. The oligopolistic structure of the banking sector has delivered huge profits to the main players. Indonesia's net interest margins (the difference between lending and deposit rates) are the highest in the region. This is one of the factors that explains Indonesia's high real interest rates (Figure 17), which discourage productive investment and particularly damaging to small enterprises that cannot borrow overseas.[39]

Figure 17. Real interest rates, 2000-2009



Source: Economist Intelligence Unit

The Financial Services Authority (OJK) has not yet developed the technical capacity or political autonomy to conduct rigorous and independent bank regulation and supervision due to begin sometime in 2011. In the meantime, Indonesia's efforts to re-regulate and consolidate the banking system after the East Asian financial crisis have had the unintended consequence of concentrating credit risk while reducing access to financial services. Most banks appear to be chasing the same customers in the same locations with the same conventional products at comparable pricing (Rosengard, Patten, Johnston and Widjojo Koesoemo 2007).

Thus, the challenge facing Indonesia is to promote a more inclusive financial system by eliminating regulatory biases against rural and innovative banking while introducing more competition into main-

[39]Another factor is Indonesia's open capital account. High interest rates draw in foreign capital, which further strengthens the exchange rate, forcing BI to intervene in the currency market. High nominal rates on BI instruments (SBI) provide the banks with a low risk, high return alternative to commercial lending.

stream banking by reducing barriers to entry and eliminating the bias for large banks. The government must also enhance the capacity of OJK through technical and executive training, as well as the recruitment and hiring of externally-sourced regulatory expertise.

4. Institutional Transformation

[E]very institution of national and local government was functionally debased during the New Order period. It was not simply a matter of corrupt practice, but also and more deeply one of ethos, of a reorientation away from legally defined responsibility (not least to the public) and towards the privileges, rewards and opportunities that followed from linkage to political power.

Daniel Lev (2007)

This party is like a wastebasket. But that doesn't mean we don't have principles.

Subur Budhisantoso, Chairman of the Democrat Party, *2001-2005*[40]

Institutions are "the rules of the game," or, in one succinct formulation, "systems of established and prevalent social rules that structure social interactions" (Hodgon 2006, 2). Institutions are the rules that shape our economic, political and social behavior. They include, but are not limited to, formally constituted organizations like government agencies, political parties and firms. In addition to organizations, institutions include laws, language, markets and norms of acceptable behavior.

[40]Slater 2004, 86.

Institutions shape our economic, social and political lives. But they do not necessarily function well. We do not really know why some societies manage to create good institutions—meaning institutions that uphold justice, resolve social conflict and promote economic growth with equity—and others do not. It is also evident that dysfunctional or bad institutions can persist for a very long time. They can be "locked in," because the potential winners from growth or equity-enhancing institutional change cannot compensate the potential losers, or potential winners do not have sufficient political power to effect and enforce change. A small number of people who benefit from bad institutions can block change if the majority cannot organize themselves politically to take advantage of their greater numbers.

Because of institutional "lock in," the legacy of the past weighs heavily on the quality of our present-day institutions. Rich and powerful people who benefit from dysfunctional institutions will not give up their privileges unless they can see how institutional change will be good for them, or they are forced to give up the fight by someone or something more powerful than themselves. The past is important for another reason. Institutions are shaped by our ideas about what is acceptable and proper. We develop certain habits of thought that are at once influenced by existing institutions and also set the parameters for institutional change. Ideology and patterns of political behavior do not change overnight. Cultural change is both a cause and effect of institutional change.

Indonesia is not the only post-authoritarian government in Southeast Asia. The Philippines and Thailand are also trying to build stable and accountable democratic institutions and to achieve economic growth with equity. However, the institutional context of the three countries is very different. Indonesia's New Order lasted longer, and penetrated more deeply into society and the economy than authoritarian regimes in the other countries. The Suharto regime centralized power and smothered autonomous political activity to an extent that would not have been possible in the Philippines with its powerful landed elite or in Thailand with its older and more established business elites and middle classes. Although the New Order enjoyed broad support from business and some sections of civil society in its early days, by the end of the regime political and economic power emanated solely from the palace, and even mild dissent was no longer tolerated. The label "sultanistic regime" is therefore an apt description of Suharto's final years in power (Winters 2010, Chapter 5).

The *reformasi* era has dismantled much of the formal institutional infrastructure of the New Order. Although Indonesia's democratic experiment is still in its infancy, much has already been achieved. The political system is remarkably open and power has been decentralized from the center to the regions and from the executive to the legislature. But many of the fundamental institutional challenges of reform have not yet been addressed. An exceptional opportunity was missed in the early days of *reformasi*, when opposition groups failed to form a united front, thus leaving the initiative to remnants of the New Order. At this decisive juncture in its history, Indonesia did not have a chance to articulate a new vision of politics, economy and society. Partly as a result of this missed opportunity, reform has never directly challenged the nexus of bureaucratic, military and financial power that underpinned the Suharto regime.

Democracy, however vibrant, has not made a dent in the corruption and imperiousness that still pervades the bureaucracy and judiciary at all levels. Politics remains an elite affair, and one geared more to extracting resources from the state than serving constituents. Unlike Thailand and Korea, Indonesia's economic oligarchy survived the 1997/98 crisis largely intact. These wealthy individuals and companies have adapted to the *reformasi* era by diversifying their political alliances to protect assets and to gain access to government favors. Monopoly, uncompetitive behavior and rent-seeking now take new forms, but they remain as central to Indonesia's political economy today as they were during the New Order. The use of organized violence for political ends has spread from the military and central government to local government and political parties. The distinction between organized crime and mainstream politics has become blurred. Although the military has surrendered its overt political role, it has retained its territorial command structure and vast business empire, both of which are important sources of power at the central and local levels.

The institutional legacy of the New Order continues to weigh on the economy. Businesses leverage their domestic assets while moving equity overseas. Investors shy away from long term investment projects and opt for quick returns because of the absence of effective "third party enforcement"—in other words, state institutions that can be relied on to be an impartial referee in business deals. The fact that courts, administrative agencies and legislative bodies favor the rich produces an industrial structure consisting of a few large conglomerates and a mass of tiny firms. Small enterprises cannot grow into medium-scale businesses, and most prefer the relative safety and anonymity of informality.

Indonesia must improve the quality of its public institutions if it is to take advantage of the opportunities afforded by globalization. Institutional change is also needed to put a brake on rising inequality and protect people's basic rights. But there is no easy path to institutional transformation. Newspaper columnists lament *ad infinitum* that if Indonesian leaders only had the requisite political will to break through bureaucratic obstacles and tame the special interests, the country's problems could be solved virtually overnight. No doubt leadership and political will are important. But institutional change requires more than a charismatic leader or political enforcer who can impose change. We have learned from other countries that real institutional transformation takes time, and requires a combination of changing incentives, shifts in the balance of political power and changes in attitudes.

This section briefly reviews Indonesia's institutional legacy and considers a few ideas that could help put institutional transformation back on the political agenda. The issues are complex, and we ask more questions than we can answer. Our aim is less to provide ready-made solutions than to point they way towards some useful avenues of inquiry.

The Study of Indonesian Institutions

The main theme of this book is that progress in Indonesia hinges crucially on the country's capacity to overcome the legacy of the Guided Democracy and New Order eras and to transform the nation's political, economic and social institutions. Before discussing this institutional legacy, it is first worth mentioning the tremendous importance of the development of the domestic social sciences to institutional transformation.

Before we can change institutions we need to understand them. Yet Indonesian social scientists must also overcome their own New Order legacies if they are to take the lead in an objective and rigorous assessment of the country's institutions. Under-funding of higher education discouraged independent research for many years, and made scholarship less attractive to talented young Indonesians than administrative careers. Academics were also forced to maintain links to the system in order to gain access to the government and donor-financed projects that were essential to achieving middle class living standards. The end result, to use Hadiz and Dhakidae's phrase, was the "entanglement" of social science with "bureaucratic objectives" (Hadiz and Dhakidae 2005, 10).

The entanglement of social science with the bureaucracy meant that scholars lost their critical distance from government. Research was limited to topics considered to be politically acceptable and supportive of government ideology. The security apparatus enforced a ban on campus politics that constrained the ability of faculty and students alike to study situations of social conflict or dysfunctional state institutions. Discipline was strictly enforced by ample inducements to good behavior were also on offer. The social sciences were steered away from the objective analysis of the economy, society and politics and towards more narrowly technocratic aims. Political stability and the government's corporatist strategies to maintain it were assigned the highest value: discussion of ethnic, class, religious or gender-based conflict was actively discouraged. The official ideology "Pancasila" was not open to scrutiny.

Reformasi has swept away most of the explicit controls on academic expression that degraded the social sciences during the New Order. Unfortunately, freedom has not translated immediately into critical, high quality research. One of the main problems is the chronic underfunding of universities. Academic salaries are still low and talented researchers and teachers still move on quickly to other professions. Those that remain find that they must moonlight or consult to survive. Research is limited to income generating projects leaving little time for independent, peer-reviewed scholarship (Heru Nugroho 2005, 144). There is a great demand for critical analysis in Indonesia that is not currently being met by academic publications and the "quality" newspapers and magazines (whether print or electronic), as demonstrated by the tremendous public interest generated by George Junus Aditjondro's *Membongkar Gurita Cikeas*. The success of the book reflects a widely held public perception that the mainstream media is not telling the whole story. What is missing is a community of active researchers committed to high standards of integrity that has the time and resources to move beyond sensationalist accounts like *Gurita*.

Box 5. Banning Books

The Justice and Human Rights Ministry and the Attorney General's Office are reviewing two hundred recently published books, twenty of which are likely to be banned in Indonesia. The banned books address a range of topics, including separatist movements in Papua and the Maluccas, the events of September 30, 1965, corruption and the history of the New Order.

According to Hafid Abbas, the ministry's research and development division head, "We are facing a silent war against foreign adversaries who are trying hard to destabilize Indonesia's sovereignty through publications. Therefore, we have to be prepared and fight back."

A "Clearing House" team consisting of the AGO, the Religious Affairs Ministry, the National Education Ministry, the Information and Communications Ministry, the National Police, the State Intelligence Agency, the State Information Agency, the Indonesian Military and the Indonesian Ulema Council has the authority to propose titles for review and to ban books.

Previously, the AGO had banned five books in Indonesian, including the translation of *Pretext for Mass Murder: The September 30th Movement and Soeharto's Coup d'Etat in Indonesia* by John Roosa. Others include *Six Paths to God* by Darmawan M. M, and *Resolving the Mystery of Religious Diversity* by Syahrudin Ahmad. The two other banned books were The Voice of Churches for Suppressed People, *Blood and God's Tears in West Papua* by S. Sofyan Yoman, and *Lekra Never Burns Books* by Roma Dwi Aria Yuliantri and Muhidin M. Dahlan.

Book authors and publishers can challenge the team's decisions in the administrative court. A group of NGOs is currently planning to file judicial review requests with the Constitutional Court over the laws governing book banning

(Summarized from "Banning Looms as Draconian Officials Remain," *The Jakarta Post*, January 10, 2010.)

Overcoming the legacy of the New Order in higher education more broadly will take time. Universities have greater autonomy than in the past, but they retain the habit inculcated over more than three decades of serving government agencies rather than maintaining a critical distance. Academics still aspire to senior positions in government as advisors or even high ranking bureaucrats. The selection of top university leaders still requires government approval even as public sector funding has declined and universities have become more dependent on fees for basic operating expenses.

The transformation of the social sciences and of universities in general is an important factor in Indonesia's institutional transformation. Recreating a culture of rigorous scholarship and critical thought is an important step towards re-examining the past to arrive at a better understanding of the legacies of Guided Democracy and the New Order. Revisiting the events and implications of these crucial periods in the nation's past will not be easy. Some discord and discomfort will inevitably be part of the process. But the viability of Indonesia's democracy depends on the country's willingness to confront the truth and to learn from it. Only then will Indonesia be ready for an honest and inclusive debate about the proper contents and scope of reform.

The Institutional Legacy

Contemporary Indonesia has inherited problematic institutional legacies from the Dutch colonial state and successive national governments that have ruled since the 1950s. This book is not the proper place to provide a comprehensive analysis of the country's institutional development and the relevance of historical factors to modern day institutional dysfunction. We focus on five dichotomies that we believe are of central importance to this legacy and to understanding Indonesia's contemporary political economy. These dichotomies are: military versus civil rule; integration versus decentralization; the "floating mass" versus democratic participation; rule of law versus rule by law and patrimonialism versus institutional development. We believe that a close examination of these facets of Indonesia's institutional legacy can help us to understand the main obstacles to change in the *reformasi* era.

Military versus civilian rule

Civilian control of the military is a precondition for democratic reform. It has not yet been achieved, and it is unlikely that the other institutional changes discussed in this section can be realized in its absence. The deep involvement of the military in Indonesian politics began with the declaration of martial law in March 1957 in response to regional unrest, and was institutionalized under Guided Democracy.

Daniel Lev makes the point that although Guided Democracy is usually remembered as a ploy by then President Sukarno to seize absolute power, the real architect was Army Chief of Staff Abdul Haris Nasution. His plan included the creation of "functional groups" (*golongan karya*) to replace political parties, which under Suharto was elevated to the status of a ruling party (Golkar); the 'Middle Way of the Army," which later became the doctrine of the military's dual function (*dwi fungsi*); and a proposal to restore the illiberal Constitution of 1945, a decision that still has not been reversed. Active officers entered the cabinet and regional administration, and in 1960 Masyumi—the modernist Muslim party that had placed second in the 1955 elections—was banned for its involvement in the PRRI rebellion.[41] The territorial command structure, in which the army maintains a presence in every district and village, was also institutionalized in the 1950s, and the army took control over the police in 1962. Thus the military had already laid the foundations of the New Order by the early 1960s (Lev 2007, 240). The only remaining obstacles to military dominance were Sukarno and the PKI.

If Suharto did not invent the instruments of the New Order, he deployed them to maximum effect. The army was allocated seats in parliament, retained control over governorships of populous or otherwise sensitive provinces and active officers were assigned key positions in the bureaucracy. Officers were granted lucrative mining and timber concessions, import licenses and other financial privileges, which they parlayed into close business relationships with Chinese-Indonesian businesses that had capital and managerial capacity but lacked political protection.

The main pillars of military power are the territorial command structure, self-financing (in other words, a degree of independence

[41]Masyumi was an abbreviation for *Majelis Syuro Muslimin Indonesia* (Council of Indonesian Muslim Associations). The PRRI or Pemerintah Revolusioner Republic Indonesia (Revolutionary Government of the Republic of Indonesia) was a Sumatra-based rebellion backed by factions of the military that sought greater regional autonomy.

from the central government budget) and immunity from the civil courts. Self-financing, which dates back to the independence war, has taken many forms, including control over local government budgets and natural resources, business ownership, protection rackets and extortion. The army seized control of Dutch banks and plantations in 1957-1958, many of which remained under military control. Financial autonomy from government evolved into an important source of military power and resistance to civilian control.

Since the revolution, military officers have never accepted the competence of civil courts to hear cases involving active officers. No one in the Indonesian armed forces has been tried for violations of human rights, for killing civilians in Timor Leste, Aceh or West Papua, or for that matter Jakarta or Lampung. Military intelligence officers have not been tried for torturing and killing opposition figures during the New Order. In an important test case, former Deputy Chief of Indonesian National Intelligence Muchdi Purwopranjono was charged for the murder of human rights activist Munir Said Thalib, who died of arsenic poisoning on board a Garuda Indonesia flight to the Netherlands in 2004. He was acquitted in December 2008. Former Garuda pilot Pollycarpus Budihari Pariyanto was convicted of the murder and sentenced to twenty years in prison in January 2008.

Underpinning these various dimensions of privilege is the military's conviction that it is the only institution capable of safeguarding national unity in a context of pronounced regional, ethnic and religious diversity. The military also sees itself as a bulwark for stability, elite consolidation and routinization of politics and as a counterbalance to the radical populist strand of Indonesian nationalism (McVey 1983, 87).

Demilitarization of politics was a central demand of the pro-democracy forces in the early days of *reformasi*. Some major milestones have indeed been achieved over the past decade. The military has lost its representation in parliament and its control over the police.[42] Active officers can no longer serve in the civilian bureaucracy. Parliament has required the military to surrender all of its businesses to the state, although the government has so far failed to enforce the law. The government negotiated a lasting peace in Aceh, which has been supported by the military leadership. National unity has replaced *dwi fungsi* as the military's governing principle.

Nevertheless, the larger goals of eliminating military influence from politics and professionalizing the armed forces have not been achieved. The most important source of military power remains the territorial command structure, which provides the army with a channel through which it can intervene in local politics and gain access to local government financing. Administrative and financial decentralization enacted in 1999 has raised the value of the territorial command since districts now have more resources and decision-making power. Retired officers often return to the regions in which they served as politicians, bureaucrats and businessmen, a practice that began during the New Order. Local army commands are still responsible for gathering intelligence, a mission that had at one point been reassigned to the police. Active officers still dominate the Ministry of Defense, including procurement of military hardware.

Although instructed by parliament to surrender its financial interests to the government in 2004, the military has attempted to finesse the issue by interpreting the law to exclude the approximately one thousand cooperatives and 23 foundations in which most of these assets reside. The value of the military's assets is estimated at $350 million on which it earns annual profits of $28 million. Total debt is thought to be about $100 million (Demopoulos 2010). The army also sold off some of its most valuable assets before the deadline, although the proceeds from these sales have not reverted to the government treasury (Mietzner 2009, 362). Meanwhile, successive governments

[42]However, like the military, the police are not held accountable to local communities, and have also engaged in protection rackets and other forms of extortion. Competition between the police and army has created tension in places, even at times spilling over into armed conflict.

have failed to increase defense spending in the national budget to replace resources generated internally.

Retired officers are still prominent in national and local politics. All three presidential tickets in the 2009 elections contained one retired general, and three of the major parties were founded by generals and have a high concentration of military figures in their leadership (the Democrat Party, Gerindra and Hanura).

The ability of the military to maintain its privileged position during *reformasi* is partly explained by continuing security concerns. Violent ethnic and religious conflicts (although in some cases stirred up by factions of the military) have provided a justification for the territorial command structure. So has the rise of domestic terrorism since 2002 and separatist movements in Aceh and West Papua. But as Mietzner points out, the fundamental obstacle to deeper reform of the military in the post-Suharto period is the fragmentation of civilian leadership (Mietzner 2006, 44). During the *reformasi* era, civilian politicians have repeatedly called on support from military figures in their intra-elite political battles. Abdurahman Wahid's backing for the 2004 presidential candidacy of General Wiranto, whom he had sacked during his own presidency, and his endorsement of General Prabowo Subianto's Gerindra Party in the 2009 elections illustrate the problem. So does the "odd couple" of the *reformasi* period, the 2009 presidential ticket of Megawati Soekarnoputri, a leading symbol of the anti-Suharto resistance, and General Prabowo, Suharto's former son-in-law and die-hard supporter who was forced into early retirement from the army for his role in the abduction and murder of pro-democracy students in 1997-98.

The military's continuing role in the country's political life has a chilling effect on political discourse in Indonesia. As long as civilian politicians recruit retired senior officers to aid them in their intra-elite conflicts, Indonesians will not be able to engage in an honest and thoroughgoing assessment of thirty years of military rule. Most crucially, Indonesia can never have anything even vaguely approaching a free and representative democracy until the public engages in an open and honest discussion of the history of the New Order, including the 1965-1966 massacres and the ensuing arrest of half a million people accused of real or suspected links to the Communist Party. School textbooks still contain the military's version of these events, and scholarly books on the subject are still banned (Tan 2008). Real democracy cannot take root in soil poisoned by denial and lingering injustice. But truth and reconciliation in any form is unlikely to be permitted as long as the army remains a powerful political force.

Integration versus decentralization

The tension between Indonesia's unitary state and the centrifugal forces of separatism and regional autonomy is a recurring theme in Indonesian history. Indonesia is indeed an unlikely country, formed by Dutch colonialism from some seventeen thousand islands and more than three hundred ethnic groups. Of the estimated seven hundred languages spoken by Indonesians, twenty have at least one million native speakers. Although about 60 percent of the population lives on the island of Java, less than two-thirds of Java's inhabitants identify themselves as ethnically Javanese and speak the Javanese language. Nevertheless, it is not an exaggeration to say that most of the people live on Java while the bulk of the country's natural wealth is on the other islands. This is one of the central dynamics of Indonesian political economy.

Federalism is one way to balance competing local interests in a country of such great diversity. But this option was ruled out early, tainted by association with the Dutch-inspired United States of Indonesia. The Republic of Indonesia that replaced it was unitary in name, but struggled to create a functioning, coherent state from the remnants of the colony, veterans of the guerilla war and the various revolutionary and religious leaders, political parties, factions and local elites that had supported the nationalist cause. The underlying material conflict pitting populous Java against the resource rich Outer Islands was never far from surface. The high turnout for the heavily Java-centric Communist Party (PKI) in the 1955 national elections made it clear to all that the unitary state would not only be secular (if not atheistic) but that it would also seek to redistribute wealth from the Outer Islands to populous Java. The PRRI and Permesta rebellions in 1957-1958 were unsuccessful attempts to break Java's ideological and economic grip on the nation-state (Winters 2010, Chapter 5).

Regional rebellions provided a justification for martial law, the end of parliamentary democracy and local control over the bureaucracy and the penetration of the military into central and regional government. By the early 1960s, the Indonesian state finally achieved military control over the entire archipelago (Anderson 1983). The armed forces have since that time continued to view itself as the only institution capable of maintaining Indonesia's territorial and political integrity. Defense of the unitary state was a pillar of the New Order's political legitimacy, and the army propagated an ideology that associated regional unrest with parliamentary democracy. The imperative of maintaining national unity provided a justification for the army's territorial command structure and the appointment of military officers to head provinces, cities and districts. The unitary state also gave the army access to the vast natural wealth of the archipelago, unimpeded by local elites (*Ibid.*). Law No. 5 of 1974 formalized the highly centralized structures of public administration and finance that remained in place until the fall of Suharto in 1998. New Order laws consistently strengthened the center's grip on oil, mineral and forest resources.

The oil boom provided the central government with resources to spend on infrastructure, which were distributed to the regions as Presidential Instruction (*Inpres*) grants (Winters 1996). *Inpres* tied poorer regions closer to Jakarta, but was less important politically in resource rich provinces, which were losers in the national redistribution of wealth entailed by centralization. Local elites in these areas lost control over resource rents, but obliging local leaders were compensated with other patronage opportunities emanating from the central state. Nevertheless, the undercurrent of popular dissatisfaction with this arrangement rose to the surface from time to time, particularly during election periods. Awareness of the latent potential for defiance of Jakarta in resource rich regions was one the main reasons for the extreme levels of violence unleashed by the army against separatist movements in Aceh, Timor Leste and Irian Jaya (West Papua). The message was sent that accommodation with Jakarta brought rewards, but resistance would be crushed (Malley 1999).

Transmigration was another important vehicle in the creation of a unitary Indonesian nation-state. Voluntary and forced migration from densely populated Java and Bali to the land-abundant Outer Islands began in the colonial period and continued under Presidents Sukarno and Suharto. While the expressed intent was to improve the living standards of land-poor Javanese, the subtext of transmigration was the spread of a homogenized national culture, based primarily on Javanese notions of village life. Rampant corruption, human rights abuses and ecological disaster led to a decline in voluntary migrants and eventually to a loss of international support (Hoey 2003). Nevertheless, the government claims that nearly seven million people were relocated during the New Order. With the collapse of the regime and its security apparatus in 1998, clashes between transmigrants and local people in Kalimantan and Sulawesi led to hundreds of deaths and forced many thousands of migrant households to flee transmigration sites. It is likely that the legacy of conflict has discouraged voluntary migration of people between islands, thus limiting the flow of skills among locations and blocking the equalizing effects of mobility. Transmigration is still an official program of the government, under which about 470,000 people have moved since 2000.[43] However, the program is now small relative to voluntary, non-program migration.

The New Order's political legitimacy was based on the proposition that centralization and military rule were essential for stability and development. Parliamentary democracy was associated with instabil-

[43]Official transmigration figures are available from the Ministry of Manpower and Transmigration website, http://www.nakertrans.go.id/pusdatin.html,8,352,ptrans (accessed December 11, 2009).

ity and regional separatism. It was therefore no surprise that extreme centralism did not survive the return of parliamentary democracy. For a time, it seemed that the very survival of the unitary state was in question. Timor Leste voted for independence and the Free Aceh Movement and Free Papua Movement demanded referenda to recast their relationship to the Indonesian state. Some wondered whether the separatist impulse would spread across the archipelago. In the event, peace was achieved in Aceh under a framework of regional autonomy and West Papuan separatists failed to overcome their internal divisions.

The more lasting issue remains the distribution of economic and political power within the unitary Indonesian state. The Habibie government retained the military's concerns about the rise of separatism and its rejection of federalism. The form of decentralization put forward in 1999 bypassed the provinces and shifted two million civil servants and 60 percent of government revenues from the center to districts and cities. Districts were also given greater control over natural resources, resulting in acceleration in the rate of forest destruction. The number of small scale mining licenses has also risen sharply: for example, 2,513 coal mining licenses were issued by local authorities between 2001 and 2008 (Darmawan Triwibowo 2010). New decentralization legislation in 2004 strengthened the role of provinces and attempted to bring more order to the chaotic relations between the central and regional levels of government. The Ministry of Forestry has also attempted to reassert control over timber concessions in 2002 and 2007 (Moeliono, Wollenberg and Limberg 2008). Direct election of district chiefs, mayors and provincial governors was introduced in 2005.

Decentralization combined with a new, open political system has created opportunities for greater accountability to local constituents, but has also increased the demand for political resources. There are more allegations of local corruption partly because the system is more open, but also because there is more corruption (Syarif Hidayat and van Klinken 2009, 149). In most localities, there has been a remarkable consistency in the cast of characters who make up the political elite from the New Order to the present. Although most local political leaders still emerge from the bureaucracy and military, candidates for local office are also drawn from what is euphemistically termed "the business community." These business people are often linked to some kind of New Order relationship to the military, government or individual political patrons. The proliferation of new districts (*pemekaran*) reveals the underlying logic of the system, which is to draw down resources from the center to spend on local administration. District leaders can be found who have pursued a strategy of building a loyal local following by providing better services. But they are the exception rather than the rule. More common is the creation of "political godfathers," many of whom amassed great wealth and political connections during the New Order through positions in the army, the bureaucracy and Golkar.[44]

The "floating mass" versus democratic participation

The architects of the New Order political system saw political engagement as a distraction from the hard work of development. The people were viewed as a "floating mass" that should not be distracted by politics except for brief periods leading up to elections ("festivals of democracy"). Elections would offer them a choice between three government-backed parties, all of which subscribed to the national ideology Pancasila but which carried some residual historical loyalties. The United Development Party (PPP) was constructed from the pre-New Order Islamic parties and therefore retained some religious overtones. The Indonesian Democratic Party (PDI), a mix of the Indonesian Nationalist Party and some Christian parties, carried some suggestion of a Sukarnoist opposition. But even these muted differences were less than they seemed, since the two "opposition" parties

[44]For an example from South Sulawesi see Buehler 2007. Anita Yossihara and C Anto Saptowalyono (2010) report on a similar political dynasty in Banten province.

were staffed by government operatives and banned from organizing in the regions. Meanwhile, all civil servants were by law members of Golkar, the government's electoral vehicle, as were members of government-led corporatist groups representing workers, farmers, business and others. Political competition was declared antithetical to the ruling ideology Pancasila and therefore un-Indonesian. The press and civil society groups were strictly controlled.

Reformasi has dismantled this corporatist-authoritarian apparatus. One hundred fifty political parties registered for the first free elections in 1999. Curbs on the press and civil society were largely lifted. Golkar and Pancasila lost their privileged position in the political system. Yet after ten years of *reformasi* the quality of democratic participation has not noticeably improved. We can discern several reasons for the failure to translate greater political freedom into effective grassroots organizations and movements. First, the failure of the political opposition—which had initially called for more radical change under the banner of *revolusi*—to seize the initiative in 1998 created a vacuum that was filled by remnants of the New Order, which focused on the narrow procedural elements of *reformasi*. They blocked efforts to undertake a broad, critical reassessment of the Suharto period and the articulation of a substantive reform program that went beyond political liberalization and decentralization. Second, the leaders of the opposition were themselves a product of the "floating mass" mentality and shared the military's fears that mobilizing peasants and the urban lower classes would lead to political instability (Hadiz 2000, 23). They were content to continue playing the kinds of intra-elite games that had characterized the New Order, and with which they were most familiar. Third, the sheer effectiveness of the floating mass policy left post-New Order civil society groups ill-prepared to begin the hard work of building genuinely grassroots, representative organizations. Adept at receiving resources from government and donors and distributing benefits to specific groups, they had little experience in community or issue-based organizing, and in most cases no inclination to learn these skills. Fourth, the legacy of the 1965-66 massacres still has a chilling effect on political mobilization, both because disenfranchised groups fear reprisals from the military and generalized fears of a repeat of the terror of 1965-1966.

Politics in the *reformasi* period has remained a process of intra-elite horse trading, and has retained the New Order premise that social conflict is best averted through the systematic co-optation of political elites. Dan Slater explicitly links what he calls "collusive democracy" to the floating mass policy: only elites can practice politics without resorting to violence, and conflict can be minimized by making sure no elites are excluded from the distribution of benefits associated with political power (Slater 2004, 79). Collusive democracy is evident in the careful balancing of parties within the cabinet, the absence of opposition parties in parliament and the promiscuous and unstable nature of political alliances as parties form and re-form alliances based on short-term considerations and largely innocent of ideological commitments or the interests of their constituents.

Another legacy of the floating mass is political gangsterism or *premanisme*. As Indonesian society urbanized in the 1980s and 1990s, the Suharto regime mobilized local gangsters or toughs (*preman*) in organizations such as the *Pemuda Pancasila* (Pancasila Youth). They proved useful in breaking strikes and disrupting opposition demonstrations, and in filling out crowds at pro-government rallies during election time. The leadership of these organizations became adept at acquiring resources from the regime in the form of handouts, jobs and government contracts. Hundreds of *Pemuda Pancasila* leaders and alumni of similar groups are now sitting parliamentarians and elected leaders at the national and local levels. They have used their military and government connections, access to resources and often the threat or use of violence to build political machines at every level of government and across the party spectrum. They have proven particularly useful to parties other than Golkar which had no political organization at the local level in 1998 (Ryter 2009).

Although the country's heterogeneity makes it difficult to generalize about local politics, Indonesia could be heading towards a form of local bossism similar to that which has developed under post-authoritarian regimes in the Philippines and Thailand.[45] The disillusionment of the electorate has opened the way for local bosses of various kinds to acquire executive and legislative posts through self-financing of campaigns and buying the support of national parties. These politicians leverage institutional and financial resources derived from backgrounds in the military, the bureaucracy, business and gangs to build local political machines, which in turn deliver state favors to entrenched patronage networks. Local elections in many places have become competitions among political elites for the spoils of office, while pressing social and economic issues have largely fallen off the agenda (Choi 2005).

Rule by law versus rule of law

The rule of law is not a procedural issue: it is a question of the distribution of power. Indonesia's first, brief experience of parliamentary democracy was the only period in the country's history during which the legal system possessed sufficient autonomy from the government and military to function effectively. The fact that no single party was in a position to dominate the government, combined with the presence of active labor, peasant, religious and other non-state organizations, created space for legal institutions to operate with a greater degree of autonomy than before, or since (Lev 2007, 239). This autonomy was lost during Guided Democracy. The early years of the New Order government drew support from groups seeking a return to *negara hukum* or rule of law, as Suharto, a career military officer, sought legitimacy for his new government in constitutionalism and the appearance of legality (Lev 1972, 271). Hence the constant reference to the Constitution and statutory law as the basis of decrees and bureaucratic orders—rule by law—despite the obvious subordination of parliament and the courts to the president backed by the military and civilian functionaries in the agencies of the state.

[45]See Sidel 1999 for an analysis of bossism in these countries.

Box 6. Controversial Legal Cases Involving Foreign Companies

The Supreme Court reversed a 1 trillion rupiah ($97.13 million) libel ruling against *Time* magazine in 2009 over an article alleging that Suharto and his family had amassed a $15 billion fortune. The lengthy legal battle against the publication, owned by Time Warner Inc., was seen as a key test of the country's legal system and freedom of speech.

A Jakarta commercial court in 2004 declared a unit of Britain's Prudential Plc bankrupt, saying the firm owed a consultant $400,000. Prudential insisted the Indonesian operation was financially strong and won on appeal.

A Jakarta court ordered a unit of BP PLC to pay $2 million in damages in 2004 for severing ties with PT Mestaco, a former supplier of chemical materials used to extinguish fires. BP had discovered that they chemicals were contaminated by a substance that could trigger explosions. That was confirmed in tests by an Indonesian police laboratory and a laboratory in Singapore.

In 2004, the Medan district court ruled against Rowe Evans, a British agro-industry group, ordering the company to return a plantation in North Sumatra to its original owner, a powerful local politician and businessman. Rowe Evans had paid $2.8 million in cash for the plantation, part of a $6 million investment in palm oil processing.

A local unit of Canada's Manulife Financial Corp was declared bankrupt by an Indonesian court in 2002. The Supreme Court later overturned that ruling.

Source: Reuters http://www.reuters.com/article/latestCrisis/idUSJAK480048, accessed July 23, 2009

Despite this surface legality, the New Order oversaw the complete devastation of the legal system. In the words of Daniel Lev, "the courts were corrupt and politically submissive, the prosecution and the police abusive, statutory law out of date but in any case often marginal and ineffectively enforced" (Lev 2000, 3). The problem was structural, not epiphenomenal. Rule of law represented a direct challenge to the supremacy of the military and the ever tightening bonds between the military, the bureaucracy and the rising conglomerates. In this, the New Order was not qualitatively different from Guided Democracy, except that unlike the latter it insisted on a patina of legal niceties in place of revolutionary rhetoric. The Suharto government's decision to attract foreign investment also raised the economic stakes of control over political power (Lev 1978, 66). Judges, prosecutors, police and bureaucrats engaged in ever more brazen varieties of corruption, including auctioning off potentially lucrative cases to judges, buying positions and passing money up the hierarchy from the lower courts to the Supreme Court (Lev 2007, 244). Local business interests have routinely used corrupt courts to extract concessions from foreign companies (See Box 4).

Rule of law is, by all accounts, the weakest link in the *reformasi* chain (Davidson 2009, 299). Legal reform is the main casualty of a democratic movement that was left to drift when Suharto departed the scene and in one step removed the only political objective that had held the *reformasi* coalition together. The Supreme Court has stonewalled reform efforts as sitting judges realize that genuine reform can only go ahead once they have been removed. In a classic case of institutional lock-in, legal reform is held hostage to those who have the most to lose from institutional change. Much the same can be said about the public prosecutor's office, the police and the lower courts.

One positive step was the establishment of the Constitutional Court in 2002 with powers of judicial review over new legislation and the role and functions of major government branches. The court has shown a willingness to take on the politically unpopular causes, for example scrapping laws that banned people accused of association with the Communist Party of Indonesia from political participation. The court also threw out provisions of the criminal code that made defaming the government a criminal offense. However, parliament explicitly blocked the court from considering laws promulgated before 1999. In other words, the entire body of New Order law was considered too controversial to allow judges to rule on its constitutionality. It is difficult to see how Indonesia can move beyond the legacy of the New Order if the laws from that period are not subject to the same scrutiny as laws enacted by a democratically elected parliament.

The root cause of the failure of legal system reform is the distribution of political power, which has yet to see a decisive change under successive *reformasi* governments. The military remains powerful, and civilian politicians of all stripes have clung on to their political relationships with retired and active soldiers. The bureaucracy, a product of three decades of military rule, has not developed a conception of citizens' rights or public service. *Reformasi* era politicians notionally represent different constituencies, but their behavior suggests that for the most part they represent only themselves and the chains of clients attached to them.

Such a political class is unlikely to welcome an autonomous and effective legal system. The preferred strategy is to create new institutions rather than fix the existing ones. In addition to the Constitutional Court, Indonesia has created commercial courts, administrative courts, and the National Commission on Human Rights and the Corruption Eradication Commission, among others. These institutions suffer from the same internal weaknesses and are subject to the same external pressures as the Supreme Court and lower courts.

Patrimonialism versus institutional development

The New Order regime centralized power in the executive, and increasingly in the hands of one person, the president. No independent loci of power were permitted. Parliament was a rubber stamp, the political parties were manufactured by the regime and subservient to it, the press was tightly controlled and the judiciary rendered toothless. President Suharto used the distribution of patronage and commercial favors to tighten his grip on the armed forces. The New Order was a paradigmatic Weberian patrimonial state, under which the bulk of the population is rendered politically passive while the ruler manages intra-elite competition through the distribution of offices and favors (Weber 1946, 297).

Many observers accepted this characterization of the regime but argued that economic development would increase the demands on the bureaucracy for predictability and regularity. Discretion and informality would increasingly give way to rule-based government and formal institutions (Emmerson 1983; Liddle 1985). The rise of the urban middle classes and academy-trained officers who were concerned about the long-term legitimacy of military rule were also cited as factors that would contribute to the taming of patrimonialism (Crouch 1978). The prominent role of the western-educated "technocrats" who ran the economic ministries reinforced the perception that the New Order, whatever its imperfections, was a force for modernization and a victory for rational bureaucracy over the chaos of Guided Democracy.[46]

In the end, it did not work out that way. As Suharto marginalized the remaining dissenters in the military, "the New Order state became even less oriented to the organizational interests of its agencies and more attuned to the private interests of power holders" (Hamilton-Hart 2002, 46). By the 1980s, the institutions of government were routinely undermined to deliver favors to the president's family and closest associates. The state became increasingly "sultanistic"—an extreme form of patrimonialism marked by the absence of competition even within the political class.[47] The small, urban middle classes, divided along ethnic and religious lines and tied economically to the state and state-related businesses, acquiesced without a struggle. In fact, the better off segments of urban society were more concerned to protect their relatively privileged position vis-à-vis the swelling urban underclass than in mounting an organized challenge to the regime.

[46]Mohammad Sadli, one of the original technocrats, noted that the technocrats themselves were not skilled at building institutions (Sadli 1993). Hamilton-Hart concurs, citing evidence the apparent inability of Professors Widjoyo and Ali Wardhana to retire themselves (2003, 49).

[47]Winters 2010, Chapter 5; Linz and Stepan 1996, 52.

Institutional failure was not an unintended consequence of patrimonialism, but instead was consciously built into the system to facilitate the provision of state favors to politically connected private actors (Van Klinken and Barker 2009, 12). Hamilton-Hart's study of Bank Indonesia is instructive. She concludes that during the New Order "Bank Indonesia did not develop into a rule-based, meritocratic organization but combined a formal commitment to technocratic expertise with internal systems that were responsive to informal, sometimes even unspoken, patterns of influence" (Hamilton-Hart 2002, 65). These "informal patterns of influence" were to result in theft on a staggering scale when $11 billion worth of Bank Indonesia Liquidity Credits handed over to banks between August 1997 and January 1999 was diverted to prop up the crumbing business empires of Indonesia's oligarchs (Hadiz and Robison 2005, 227).

The main obstacles to institutional development in Indonesia are less a lack of resources or skills than the absence of accountability structures to replace informal patterns of influence with formal rules. The lesson of the New Order is that vestiges of patrimonial rule will only be removed from Indonesia's public institutions once power is dispersed in the political system to the extent that it is in the interests of all parties to adhere to universally accepted rules rather than attempt to manage intra-elite competition informally through payoffs and threats.

Reconstructing Indonesian Citizenship

At the most basic level, citizenship means membership in a national political community. Membership in the community bestows certain rights and responsibilities. In democratic societies, citizenship generally grants civil rights such as freedom of speech and religion, and political rights including the right to vote and hold public office. The responsibilities of citizenship typically include paying taxes and acceptance of the rule of law. Citizenship may also imply a minimum level of concern for the welfare of other members of the community.

T.H. Marshall famously describes a process in which civil and political rights eventually create new kinds of social rights, since full participation in the political and social life of the community can only be realized if people's basic needs are already met (Marshall 1992 [1950]).

The concept of citizenship put forward during Guided Democracy and the New Order emphasized social obligations over civil and political rights. The paternalistic notion that the Indonesian polity resembles a family (*kekeluargaan*) has deep roots in Indonesian political thinking and forms the basis of *Pancasila*, which was elevated to the status of "sole ideology" under the Suharto regime. The "integralistic" state unites the people spiritually, maintains national unity and creates harmony (Marsilam Simanjuntak 1997). Citizens achieve self-realization through obedience to the state and participation in its programs. Political competition is at best unnecessary and at worst destructive, as it may give rise to political disunity and social conflict. However, the state has a duty to protect minorities and the vulnerable members of the community to preserve order and cohesiveness in a plural society. Military rule was justified in part as a natural outgrowth of the army's role as defender of the unitary state and Pancasila.

Although the New Order is gone, Indonesia has not yet engaged in a serious public discourse on the rights and duties of citizenship under democracy. The relationship between citizens and the state has changed in formal terms, but ideas and habits carried over from the past still shape day-to-day interactions between Indonesian people and government agencies. Indonesia's constitution guarantees civil, political and social rights to all citizens. The bill of rights enacted in August 2000 was an important step forward. However, citizens are not aware of their rights, and bureaucrats continue to behave in an imperious and unpredictable manner.

Pessimists argue that Indonesian culture is unreceptive to imported notions of citizenship, and that the country has no relevant historical precedents. It is certainly true that the *pamong praja* inherited from Dutch colonialism was oriented towards social control and not the realization of rights. Javanese notions of political authority idealize just kings who do the right thing not because they are constrained by law but because of their personal virtue. Yet every country has its historical and cultural baggage, much of which is inconsistent with the realization of equal rights and formal constraints on power.[48] Lev reminds us that Indonesia's first experience of parliamentary democracy was not the unmitigated disaster portrayed in New Order historiography, much of which has been unquestioningly internalized by international observers. "[P]arliamentary governments," he writes,

> "produced strong education and health policies; debated and promulgated substantial legislation; unified the judicial system and extended it throughout the country; planned and held the first national elections; hosted the Bandung Conference in 1955; managed growing cold-war tensions; and began to situate Indonesia in an uncertain world (2007, 237).

The legal system was reasonably effective, commanded the respect of political leaders and enjoyed public trust. Judges, prosecutors and the police enforced the law, even against prominent politicians. Corruption, although a problem, was negligible in comparison with the Guided Democracy and New Order periods. Yet it has not occurred to political leaders, activists, commentators and scholars in the *reformasi* era to re-examine Indonesia's first experience of parliamentary democracy to recapture some of the ethos of that period and perhaps to avoid the mistakes that led to its demise. Such is the grip of New Order fears and prejudices on the *reformasi* mindset that open discussion of decisive moments in the nation's history is still considered too sensitive for public consumption. If this continues to be the case, Indonesia will eventually sleepwalk back towards some form of authoritarianism. One of the main lessons of the 1950s is that reconstructing citizenship

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[48]Rogers M. Smith reminds Americans convinced of their own cultural predisposition to equality and liberalism that for at least two-thirds of the nation's history the majority of the adult population was ineligible for full citizenship because of their race, national origin or gender (1993, 549).

requires a more competitive political system in which a wider range of groups in society wield power and can hold state agencies to account.

At present, disenfranchisement begins from birth. According to UNICEF, 60 percent of Indonesian children under five years of age do not have birth certificates. Half have no official registration of any kind. Although law mandates that birth certificates are issued to every Indonesian child without charge, officials continue to levy formal and informal fees. Middlemen charge from Rp 100,000 to 800,000 to acquire birth certificates, an amount that is much too high for poor people to afford. This leaves children at risk of exclusion from education and health services, and susceptible to exploitation in their dealing with government institutions throughout their lives. The failure of the registration system also lowers the quality of the country's demographic, education and health statistics and monitoring systems.

Similarly, in 2000, at most 20 percent of farmers held formal title to their land. Unsatisfactory resolution of land disputes remains the most common complaint about the justice system. Lack of title leaves farmers economically insecure and also hinders their ability to access finance to invest in farming and other activities. Even if they do possess clear title to the land, powerful actors find it a relatively simple matter to claim the land as their own in collusion with local officials. Access to justice is also severely restricted. According to a recent study, few poor people can afford to go to court, which means that most divorces are not officially recognized (see Box 7). This leaves women and children vulnerable to poverty as they have no capacity to use the legal system to force former spouses and fathers to provide support.

Legal system reform is the starting point of reconstructing citizenship. High profile cases during the *reformasi* era in which the courts have acquitted powerful business people and politicians facing corruption and other charges have reinforced the widely held view that justice is for sale in Indonesia. One of the most frequently discussed examples is the Lapindo mud flow, in which forty thousand people have been displaced in Sidoarjo, East Java by the eruption of a mud volcano on May 29, 2006. The mud volcano continues to spew out 120,000 cubic meters of hot mud per day, and is expected to do so for another thirty years (Yuni Ikawati 2010). Exploration company Lapindo Brantas, owned by the family business group of then Minister of Social Welfare Aburizal Bakrie, was drilling at a nearby site and was implicated in the disaster. Lapindo denied the charge and claimed that the mud flow had been triggered by an earthquake two days earlier in Yogyakarta, 280 km from the site.[49] The police dropped the case against Lapindo Brantas in August of 2009. For many, the case symbolized the ease with which economically and politically powerful actors in Indonesia escape punishment for serious wrongdoing. It is also a test case of sorts for two of Indonesia's new investigative agencies, the Human Rights Commission and the Corruption Eradication Commission. Both are investing the case and are expected to report in 2010.

Contrast the Lapindo case to that of Prita Mulyasari, a 32 year-old mother of two children who was arrested in May 2009 and imprisoned for three weeks for circulating an email complaint about treatment that she had received at a private hospital. She was charged with violating the Electronic Information and Transactions Law by posting her email, which claimed that doctors has misdiagnosed her case of mumps as dengue fever. The case attracted national attention when she was visited by then presidential candidate Megawati Soekarnoputri, and the courts later found in her favor. However, she lost a separate civil suit and was required to pay $22,000 in damages. She is appealing the civil verdict.[50]

The Prita case is indicative of how powerful people and institutions can use the law and the courts to their advantage. But it also

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[49]The American Association of Petroleum Geologists debated the issue at a meeting in Cape Town, South Africa in 2008. Most of the geologists present identified careless drilling as the cause of the mud volcano. See James Morgan, "Mud Eruption Caused by Drilling," http://news.bbc.co.uk/2/hi/science/ nature7699672.stm, accessed December 18, 2009. See also Davies et al. 2008.

[50]"Patient Cleared of Defaming Hospital in Indonesia," New York Times, December 29, 2009. http://www.nytimes.com/aponline/2009/12/29/world/AP-AS-Indonesia-Patient-Charged.html, accessed December 30, 2009.

demonstrates the capacity of ordinary people to reclaim the ethos of citizenship. Once Prita's story was revealed in the press, a movement began to take shape to collect money for her defense. The internet, and mostly the social networking site Facebook, was the main medium through which Prita's backers shared her story and organized her defense fund. Within a short period of time more than $60,000 was donated and delivered to Prita. Most of the contributions were coins and other small denominations. The coins were collected in drop points around the country and sent to Prita's defense team. This spontaneous outburst of activism reveals the deep sense of revulsion that many

Box 7. Most Poor Indonesians Cannot Afford Justice

"Only 17 percent of Indonesia's poor have the ability to bring their cases to court, and in poorer areas like NTT (East Nusa Tenggara) the number is under ten percent." This is the conclusion of Cate Sumner, a research for Australia's Judicial Reform Panel who led a survey on access to justice among Indonesia's poor.

The study, which surveyed 2,500 people nationwide, found that poor people cannot afford court fees and transportation costs to attend proceedings.

As a result, most divorces among the poor go unrecorded, which means that future born children may not be able to obtain an official birth certificate. According to UNICEF, 60 percent of all Indonesian children do not have birth certificates. In poorer provinces, the share is closer to eighty percent. Birth certificates cost between Rp 500,000 and Rp 670,000, which is beyond the reach of poor families.

Sumner said that Indonesia should eliminate court expenses for poor households and institute mobile courts to reduce transportation costs.

Source: Andra Wisnu (2009)

Indonesians feel about rampant abuse of power in their country. It also represents a challenge to those who argue that Indonesian culture is antithetical to rights-based conceptions of citizenship. Most importantly, it underscores the potential of citizen's movements to rewrite the rules of the game once the habits of the New Order are unlearned and the fear that for so long has held grassroots political action in check begins to subside.

The corrosive effect of abuse of power on citizenship is not confined to national headline-grabbing cases. Indeed, it is the day-to-day evidence of bias and preference that probably does the most damage. For example, Human Rights Watch recently completed a study of exploitation of child domestic workers in Indonesia. The study concluded that one of the main obstacles to improving the quality of protection for Indonesia's 700,000 child domestic workers is denial on the part of government officials:

> "Despite the widespread nature of abuses, during our research we found that many government officials consistently denied that child domestic workers are exploited or abused. Most officials attempted to refute examples of abuse that we presented to them by claiming that there were only a handful of extreme cases that therefore did not require fundamental changes in the government approach" (Human Rights Watch 2009, 2).

This example also illustrates the point that reconstructing citizenship cannot be achieved by writing laws. Although Indonesia has improved the legal protections available to child workers, these statutes are not enforced. Groups within society will have to mobilize to protect their interests and compel the state to act. If vulnerable groups like domestic workers cannot rely on the police and the bureaucracy to protect them from exploitation, they must learn to use the media, the political parties, non-government organizations and other channels of influence to increase pressure on the legal system and state agencies and to give real substance to Indonesian citizenship.

Aside from the legal and administrative systems, citizens come in contact with their state when they use public services and infrastructure. We have already seen that Indonesia's government spends less on health and education than most middle income countries in the region and beyond. Basic infrastructure is also lacking in many places. After thirty years of a developmentalist regime, it is surprising that access to electricity is patchy even in densely populated provinces like Central Java, where 35 percent of villages are still off the grid. The situation is worse for people living in outlying provinces like East Nusa Tenggara where 70 percent of villages have no electricity (World Bank 2007, 64). For citizen's living in poor areas far from Java, the state is not omnipresent and oppressive, it is absent and indifferent.

Transforming citizenship means not simply increasing the channels through which Indonesia's disadvantaged can press their claims on the state—it also means addressing the very question of who can claim membership in the Indonesian community. Formal discrimination against religious minorities has disappeared with the end of the New Order, but as is often the case, distressing informal legacies remain. Even if open violence against minorities has been muted in recent years, the continued political prominence and popularity of figures associated with that violence sends a powerful signal to minority communities that their position in the country is tenuous. The Indonesian state has traditionally dealt with the insecurity felt by the Chinese-Indonesian community by maintaining an open capital account, providing them, in effect, with an exit option should political unrest threaten their physical safety and property. The economic impact of this social contract can be debated, but what is not open to question is that the need for such a policy is indicative of a deep dysfunction in Indonesian society that must be addressed. Until Indonesia's ethnic and religious minorities are made to feel secure in their homeland, they cannot realistically be expected to become full partners in the grand enterprise of its development.

Transforming Institutions

As the preceding sections have made clear, Indonesia faces a number of serious political and social challenges: A military that has yet to be brought under full civilian control, political fragmentation wrought by decentralization, endemic corruption, weak rule of law, a depoliticized population unable to organize to hold its leaders to account, a state apparatus that remains fundamentally unresponsive to its citizens, and an impoverished conception of citizenship that does not yet embrace all Indonesians. Each of these is a product of a particular institutional dysfunction, and it is unlikely that there exists a silver bullet to solve them all. Moreover, taming the military, unifying an increasingly fragmented nation, clamping down on corruption, strengthening respect for law, and crafting democratic citizens and responsible bureaucrats are all *longue durée* processes best measured in years if not decades. The complexity and tenacity of these challenges is enough to make even the most optimistic analyst throw up her hands in despair.

Nonetheless, in the short to medium term, there are a number of relatively modest measures that Indonesia can take to set itself on the right course. These include reforming the way that political leaders are chosen, revising the relationship between the central government and the regions, using international institutions to anchor specific kinds of economic reform, involving civil society more effectively in legal system reform, and enacting targeted policies to empower and increase the ranks of the middle class.

Electoral Reform

Nearly every one of the problems discussed in this document would be easy to solve if all Indonesian politicians were honest, capable individuals whose sole concern was enhancing their country's welfare. However, Indonesian politicians, like politicians everywhere, are human beings, subject to the temptations of power and the limitations of human virtue. Short of some process by which we could peer into men and women's souls before entrusting them with public office, the simplest way to get politicians to act in the public interest is to create incentives for them to do so. And the incentives to which politicians respond most readily, because they are the most important to their survival and continuation in office, are electoral ones. Change the rules governing how politicians are elected to office, and you can change their behavior.

This important fact has not always been recognized in Indonesia. Current discussions around electoral reform focus less on how each proposed electoral system might influence politicians' behavior than on the relative complexity of each system for voters and for those who have to count votes.[51] In a July 2009 meeting with Indonesia's leading journalists, President Yudhoyono expressed his wish for "simple, short, and efficient election[s]." His desire is understandable—the KPU's five-month delay in announcing the results of the April 2009 DPR election was in part a function of a complicated electoral law that left some aspects of vote-counting (specifically, the allocation of "remainder" votes) unclear. But the simplest electoral system may not produce the best substantive outcomes.

For example, the proposal currently on the table is to shift Indonesia to a single member district (SMD) system. Under this system, Indonesia would be divided into 560 electoral constituencies, each one of which would elect a single representative to the DPR. In addition to making elections much easier to administer, the principal hypothesized benefit of this change is that it makes representatives more accountable to their constituents. After all, a legislator who has to rise or fall on his own reputation is likely to be more responsive to voters than one who is merely one name on a party list.

But SMD has other effects, not all of which are salutary. First, since the legislator's reputation, and not that of his party, is what matters, candidates appeal to voters with promises of targeted goods that they will deliver to the district instead of broad national goals that will ben-

[51]See, for example, Berly Martawardaya 2009.

efit all Indonesians. Moreover, campaigns under these systems tend to require lots of money, and since all but the wealthiest political parties are unable to adequately fund 560 different campaigns, each with its own set of micro- district-level issues, the burden of financing campaigns falls on the candidates themselves. As a result, those who run for office must either be wealthy, or have wealthy patrons to whom they are expected to render services once elected. Neither produces government that serves the interests of the poor or disadvantaged, or even the middle classes.

The second consequence of SMD is that it tends to keep out small parties, since, to capture a seat, a party must have a majority in a given district. In contrast, "proportional representation" systems assign seats to parties in proportion to their vote shares. A party that earned ten percent of the vote would thus get ten percent of the seats under PR, but none under SMD. Under SMD, small parties with strong regional bases may do well on their home turf, but if the political parties law continues to require parties to have physical offices and administrative committees in 2/3rds of electoral districts, it is hard to see how any but the largest parties will survive. The result is that a shift to a district system will produce two or three large, exceedingly weak, political parties, and that small but important minority groups will go unrepresented.

This does not mean that Indonesia should retain the current "open list" electoral system, however. In the current system, parties put forth slates of parliamentary candidates in each district; but instead of voting for a party's entire list, voters may vote for an *individual candidate* on the list. This provision was introduced by the Constitutional Court in a December 2008 ruling, and was intended to break the power of party leaders, who under the previous "closed list" system could place their cronies on the top of their lists (and thus ensure their election), and thwart the ambitions of other, worthier party members by placing them at the bottom of their lists. Under the revised, court-mandated "open list" system, each party's share of seats would go to the top votegetters on each party's list, regardless of the order in which party leaders ranked the candidates on the ballot.[52]

As admirable as the court's intentions were, the results of the court's intervention in electoral system design were largely negative. In addition to rendering elections vastly more complex (voters were confused as to whether they could vote only for an individual candidate, or for an individual candidate and his or her party), the court's formula vastly magnified the power of money in elections, and destroyed any semblance of party cohesion. Candidates of the same party were now forced to run against each other, and to spend heroic sums of money in the process. The need for candidates to recoup the money they spent in 2009, and to build up the necessary war chests for 2014, is a significant potential driver of corruption. And the intra-party competition fostered by the open list system means that political parties are severely weakened in their ability to promote broad national programs.

So where does this leave us? All electoral systems involve tradeoffs. Some systems maximize the accountability of the individual legislator to his or her constituents, but at the cost of weakening political parties, leaving minorities unrepresented, and making money the dominant political currency. Others strengthen political parties, while reducing legislative accountability and empowering party leaders to act in ways that could be seen as autocratic. Ideally, we would like a system that combines the strengths of all of these alternatives, but we court the risk of producing a system that combines all of their weaknesses instead.

Nonetheless, there is much to be said for adopting a mixed system, in which some portion of the legislature is elected according to closed-list proportional representation (CLPR) under Indonesia's current 77 multi-member districts; with the rest of the parliament elected through 560 single member districts. In Germany, which has just such

[52]So, for example, if Partai Demokrat won 70 percent of the vote in a given district, Demokrat's seats would go not to those its leaders had placed on the top of its list, but to those who had garnered the most votes. See Meidyatama Suryodiningrat 2009.

a mixed system, half of the seats are reserved for SMD, the other half for party lists. Representatives elected under SMD are accountable to their constituents, while the preservation of closed list PR ensures a continued role for political parties, encouraging them to promote national-level programs, and enables smaller parties to be represented in the legislature.

Whatever system is chosen for DPR elections should also apply to elections to the DPD and DPR-D. As it stands, Indonesia has almost as many different electoral systems as it does elected offices. Deputies of the DPR and DPR-D are chosen by open list proportional representation; while deputies of the upper chamber of parliament, the DPD (*Dewan Perwakilan Daerah*, or the Regional Representatives Council), are chosen by the single non-transferable vote (SNTV). Additionally, while DPR and DPR-D elections require candidates to be nominated by political parties, DPD elections expressly prohibit partisan candidates. Each of these different electoral systems has its positive and negative features, but taken together they constitute an ad hoc structure riddled with contradictions: some strengthening parties, others weakening them; some enhancing accountability, others mitigating it; some reducing the role of money in politics, others magnifying it. One way of responding to President Yudhoyono's stated desire to simplify elections would be to do away with this veritable menagerie of electoral systems.

Quite apart from the details of the electoral system is the question of electoral administration. Indonesia's vast size and its bewildering array of elections for every level of government mean that the smooth functioning of elections is a major task requiring significant resources. As was seen during the recent presidential and parliamentary elections--which were marred by administrative errors, disputes over the credibility of the voter registry, and allegations of vote-buying--election irregularities threaten to undermine the very credibility of democracy itself. During the June 2009 presidential election, for example, some candidates alleged that the voter registry contained as many as 20 million errors. President Yudhoyono's margin of victory was so wide that even this large number of irregularities had no effect on the outcome, but one could imagine an entirely different scenario emerging in 2014, which will likely be a much closer contest. In a tight presidential election, 20 million potential errors in the voter registry would throw any outcome in doubt, plunging Indonesia into a constitutional crisis that the country's fledgling democratic institutions would be ill-equipped to survive. Reforms such as cleaning up voter lists, improving the efficiency and transparency of electoral administration, developing stronger quality assurance mechanisms, and increasing the capacity of the general election commission (*Komisi Pemilihan Umum*) may not appear to be particularly exciting, but it is precisely these kinds of boring, technical reforms that have the greatest potential to improve the durability of Indonesia's democracy.

"Outsourcing" Institutions

Edward Steinfeld argues that after the East Asia financial crisis of the 1990s, Chinese policy makers actively deployed international rules to restructure domestic institutions. While many observers in the region viewed the financial crisis as a result of premature financial liberalization, Chinese leaders interpreted the sudden collapse of seemingly robust neighboring economies as a warning that their own institutions were similarly vulnerable. The response of the government, in particular Premier Zhu Rongji, consisted of measures that, according to Steinfeld, "tended to reach beyond Chinese borders for existing institutional strictures that could then be imposed more or less 'as is' on Chinese domestic actors" (Steinfeld 2008, 191).

By "institutional outsourcing" Steinfeld does not mean traditional policy conditionality of the kind practiced by international institutions like the IMF and World Bank. He has in mind a more fundamental, internally driven process of change in which government commits itself to international "rules of the game" as a means of restructuring domestic institutions. For example, for years China had resisted concessions to trading partners in its World Trade Organization (WTO) accession negotiations. But in the wake of the East Asia crisis, China abruptly changed tack and agreed to sharply lower tariffs on imports, a liberalized foreign investment regime and rules that would subject Chinese companies to greater competition. The government used the new rules o discipline its own state-owned enterprises and interest groups like organized labor that had resisted reform in the past.

Similarly, the largest and most important state owned enterprises listed on overseas stock exchanges, mostly in the US and Hong Kong. Although the government retained majority ownership of these firms, they were now, by virtue of overseas listing, subjected to foreign rules. They had to apply international accounting standards, appoint independent directors to their boards and meet other transparency requirements. Chinese nationals possessing overseas university degrees and years of experience in multinational corporations were invited to join their boards. They sought advice from global investment banks, law firms and other advisors. "In short," write Steinfeld, "they became accountable not just to the rules of their own government but, in very substantial ways, to those of another government" (Ibid., 194).

China's experience shows how international rules can provide an anchor for specific kinds of domestic institutional transformation. Reform of Indonesia's state-owned enterprises has been stymied by constellations of domestic interests within and outside of the state that benefit from the mismanagement of these companies. Privatization is politically controversial given that the only potential buyers of these assets are domestic conglomerates or foreign companies. Yet as China has demonstrated, ownership is less relevant to reform than the adoption of international standards of transparency and accountability. Overseas listing, the involvement of independent, international directors, and recruitment of international executives would enable the government to make a credible commitment to international rules without surrendering the benefits of ownership of these firms.

Making Decentralization Work

The move to radical decentralization was clearly underpinned by political considerations. With the fall of Suharto there was a general fear that Indonesia might be pulled apart by strong regional interests. Thus, the province was not strengthened by the decentralization measures but rather this level of government was emaciated and most powers given to the district level (*kabupaten* and *kota*). In addition, the decentralization measures addressed the concerns of many outside of Java that they were disfavored in terms of the distribution of power and resources. Law No. 22 of 1979 enabled each province to develop its own form of village governance structure thus reversing the 1979 decision to base village governance throughout Indonesia on that in Java. The Law also allowed villages to revive traditional practices and institutions, while customary law was accepted. Aceh and Irian Jaya were granted Special Regional Status. For Aceh this permitted the use of Islamic Law (Sharia) and it was allocated significant financial compensation for past abuses by the Indonesian security forces. Regional autonomy was based on five fundamental principles: democracy, people's participation and empowerment, equity and justice, the diversity of regions, and the need to strengthen regional legislatures. This process certainly improved the democratic process by opening up the system to unprecedented citizen participation. In addition, despite evidence to the contrary surveys indicated that citizens have been satisfied with the quality of service provision by the local government.

These benefits notwithstanding, it is clear that the program of decentralization and its implementation have created a new set of institutional challenges to be dealt with. While decentralization has opened up the political system for much greater participation, the speed with which it was introduced meant that there was limited consultation, ineffective assessment of the impact, and a lack of clarity about the objectives. The rush to decentralize meant that there was no coherence to the structure of multi-level governance and the new Constitution did not spell out effectively the relationships and division of powers between the various levels. The lack of coherence has been reflected in the number of subsequent attempts undertaken to improve the system. These reform attempts have tried to balance the initial moves to sub-national autonomy with better oversight and coordination from higher level government agencies. Thus, Law 32 (2004) that allowed for the direct election of sub-national leaders also reestablished central control over the hiring and firing of civil servants. In addition, the law required ex ante approval of sub-national budgets. Thus, the complete budget autonomy that had been legislated was curtailed significantly.

Despite progress, a number of problems remain concerning the distribution of functions between the different levels of government, unclear supervision of sub-national government by the central government, confusion over the role of Governor as the leader of provincial government and a representative of central government, and mismatches between expenditures and revenues. First, in terms of administration, it is clear that there can be improvements in the design of inter-governmental organizational arrangements. This would allow for more effective policy coordination. Most are agreed that the Council for Deliberation on Regional Autonomy (DPOD—Dewan Pertimbangan Otonomi Daerah), which was set up as an inter-ministerial body, does not provide the necessary coordination. It has been unable to prevent the creation of new regions, 187 new districts/cities have been added since 1999 and six new provinces, and has not been engaged in evaluation of the effectiveness of the decentralization program. It has been very poor in coordinating policy across ministries adding to the failure to bring key players together to draw up coherent policies. The failure of DPOD contributes to the fragmented and often contradictory nature of the policy-making process. One is loathe to suggest the establishment of yet another agency but unless the DPOD can be substantially revamped this will be necessary. If the DPOD cannot be given more authority and political weight there may be no alternative. Ideally, the new body, or a reconstituted DPOD, would work directly under the vice-President to provide the key organizational framework that is necessary to make decentralization work more effectively. This could be introduced in the relevant section of the 2010-2014 medium-term plan (Rencana Pembangunan Jangka Menegah Nasional). This body could review laws to prevent conflicting and even contradictory laws being passed by different government agencies and to prevent the negative impact of regional regulations.

One important role for this new body would be to draw up clear criteria for the establishment of new administrative entities. The financial incentives for forming new entities should be reviewed and the incentives for associated corruption and political patronage should be addressed. It is not clear that the proliferation of smaller administrative units has improved service provision or made the political process more open and democratic. Given the uniform distribution of functions, this has put a strain on the finances of the newer units and pushed up the per capita costs of government. One obvious way to limit this profusion would be to set clear limits to the population size of the local administrations. The profusion of new districts/cities means that provinces, on average, now have oversight of around fifteen such administrations but it is still unclear how the province will oversee them effectively. It is unclear whether the generally proposed notion of enhancing the power of the Governor as the representative of the central government will resolve this problem. The correct role of the Governor and of which functions should be carried out by the province requires further careful research.

The problems with local government financing have meant that often regional regulations are introduced to derive revenues to meet administrative obligations. These can act as an extra tax on business acting as a disincentive. Two things can be done to ameliorate this tendency. The first is that a truly effective DPOD or a new body should have the authority to review such laws for consistency and impact. Second, the ability of districts/cities to raise their own revenues can be improved; currently they raise less than 10 percent of what they need to cover. The transfer of the property tax (for urban and rural) to local governments will help but will not be enough. The duration of the transfer, currently to take five years, could be reduced and the scope expanded to include plantations carried out. This would leave the central government with the property taxes for forestry and mining.

Decentralization is a key political reality in Indonesia and has produced many benefits but unless key reforms are introduced to manage better oversight and administration and to deal effectively with financial relationships, the benefits may soon be exhausted and the necessary investments in education, health, and infrastructure will be constrained.

Legal and Judicial Reform

Legal and judicial reform is central to institutional transformation but extremely difficult to accomplish. This is partly due to the debasement of Indonesia's legal system during the Guided Democracy and New Order periods, as described above. Indonesia's judges, prosecutors, police and lawyers have no experience of a legal system in which the law stands above politicians and powerful business people, in which justice is not a service that is provided to the highest bidder. This is not to minimize the importance and courage of lawyers, activists and others who have struggled against corruption and political domination of the legal system. Few would argue with the proposition that the Legal Aid Institute (LBH) was among the most committed, and certainly the most effective defenders of the rule of law during the New Order. But even LBH could do little more than draw public and international attention to the most egregious cases of injustice. They could not stop the incessant lowering of standards and expectations as Indonesians gave up the idea that the courts had anything to do with the rule of law (Buehler 2009a, 10).

Successive *reformasi* era governments have created a plethora of new institutions to spearhead the legal reform effort. These include the Judicial Commission, set up to root out corruption in the judiciary; the Corruption Eradication Commission (KPK); a special Corruption Crimes court; the Constitutional Court to exercise judicial review over legislation; a National Police Commission to investigate wrongdoing by the police; and the Ombudsman Commission to handle complaints about public services. The president subsequently appointed an eight member Judicial Mafia Task Force. These agencies were added to the already crowded structure inherited from the New Order, which, in addition to the Supreme Court and lower courts, included the Supreme Audit Agency (an oversight body mandated by the constitution), the Human Rights Commission (Komnas HAM) and the administrative courts.

These are all important objectives, and some of these bodies have been staffed by dedicated professionals who have done their best to carry out their institutional mandate. However, the overall performance of these agencies has been poor. Granted limited authority and assigned overlapping responsibilities, they have spent a considerable amount of time and energy in turf battles amongst themselves and with parliament, the police and the Attorney General's Office (AGO). A more fundamental problem has been the absence of political support. It is difficult to escape the conclusion that the multiplication of agencies is a way for politicians to look like they are doing something without bearing the political risks of tackling the powerful interests that oppose serious legal reform. To cite just one example, the Judicial Commission reported that it had received 1,556 reports of misconduct by judges in 2008 and that it had investigated 212 of these cases. The Supreme Court did not act on any of the 27 cases referred to it by the commission (Buehler 2009a, 15).

The KPK has been the most effective of these new agencies, having secured successful prosecutions of several prominent politicians and business people. The KPK can only handle a limited number of cases from the many thousands referred to it: nevertheless, the commission has recorded a nearly perfect trial record despite its refusal to shy away from cases involving high-ranking officials. Proof of the commission's effectiveness can be found in the blistering assault launched on the agency by the police, parliament and the AGO, including threats of reprisals and trumped up charges against KPK officials. Parliament has also attacked the Corruption Crime Court Law passed in September

2009, which empowers heads of anti-corruption courts to select judges, and therefore likely reduce the appointment of more independent, ad-hoc judges (Buehler 2009a, 16). The Chairman of the Constitutional Court has also claimed in an official report that KPK officials have taken bribes to drop corruption cases (Ahmad Arif and Susana Rita Kumalasanti 2010).

Interestingly, the public has rallied behind the KPK in its recent conflicts with the police and other government agencies. A senior national police official, under KPK investigation for bribery, quipped that KPK's attempt to take on the police was like a "fight between a gecko and a crocodile." The police arrested two senior KPK officials on manufactured charges with help from prosecutors (Onishi 2009). These events sparked a spontaneous, internet-based protest movement of "geckos" in support of the KPK officials that took the political establishment completely by surprise. More than one million users of the social networking site Facebook joined an on-line protest group, and "I am a gecko" banners and t-shirts spread like wildfire. In the end, several high-ranking police officers and AGO officials were forced to resign, and the President convened a panel to review the charges against the KPK, which were later dropped.

The gecko movement revealed a strong undercurrent of public dissatisfaction with the status quo and the latent power of political organization and free speech, neither of which have been utilized much during the *reformasi* era. It is significant that political parties played no visible role in the gecko movement. Distrust of politicians from all parties is so deep and widespread that one gets the sense that any politician who had attempted to identify him or herself as a gecko would have been laughed off the political stage. The geckos are anti-politics as much as anti-corruption, the two by now being virtually synonymous. From this perspective, the geckos are a source of hope but also a cause of concern. Clearly, millions of Indonesians, rich and poor and from all parts of the country, share an abhorrence of corruption and abuse of power. They have not become so cynical as to accept the current situation as an inevitable outcome of their history and culture.

The hope is that this energy can be channeled into a specific legal reform agenda by activists in non-government organizations like—just to name a few—LBH, Indonesian Corruption Watch and the Commission for the Disappeared and Victims of Violence (KONTRAS). Minor victories like the defense of the KPK could inspire young people to organize and educate themselves about the importance of the rule of law to their country's future and their own.

However, as Daniel Lev points out, the aversion of activists and intellectuals to partisan politics effectively severs the link between reform activism and political power (Lev 2007, 252). This has the unintended effect of leaving undisturbed a political elite that has repeatedly demonstrated its reluctance to push for essential reforms. The political costs of tackling the powerful state and private interests that benefit from weak judicial system are simply too high, and the rewards too uncertain. It will take a new kind of political movement, and a new generation of leaders, to rebuild the bridges between activism and power.

Finding the "missing middle"

Earlier in this book we discussed problems associated with measuring the distribution of income in Indonesia. We suggested that official claims that Indonesia's distribution of income is relatively equal should be treated with caution. Even if we take these figures at face value, it is noticeable that more than half of the population (54 percent) lives on less than two dollars per day (in 2005 international purchasing power parity prices). This is a higher percentage than the Philippines, a notoriously unequal society (45 percent) and Vietnam, still a much poorer country (48 percent) (UNDP 2009, Table I-1). If these figures included migrant workers and slum dwellers, the percentage of poor Indonesians would even be greater.

One implication of these statistics is that the number of households in Indonesia that could be characterized as "middle class" is small relative to other countries in the region. We have discussed two possible causes of Indonesia's missing middle. First, Indonesia's jobless growth has failed to generate sufficient numbers of stable, decent jobs. This is partly a problem of lack of competitiveness, but it is also a product of official policy. Second, the license *kerajaan*, clientellism and poorly functioning capital markets represent obstacles to new business formation and to the formalization and growth of existing small businesses.

The missing middle is also apparent in the country's industrial structure. Industrial concentration ratios are high, as reported in Table 20. Even more worrying, it appears that it has become more difficult for small firms to graduate into the medium and large firm categories during the *reformasi* era. Haryo Aswicahyono, Narjoko and Hill (2008) use the industrial census to calculate enterprise transitions for the period 1990 to 2005. They detect a process of mobility in the 1990s, in which a proportion of small firms graduated into larger firm sizes. However, they conclude that this process has come to a halt during the *reformasi* period. "A clear result over the two sub-periods is that there is less mobility: more small firms remained small after the crisis as compared to before it" (2008, 25). Although the causes are not yet clear, they hypothesize that barriers to small firms expanding their scale have increased, and identify access to finance as an important factor. The burden of the "license *kerajaan*" also weighs heavier on small firms than on large companies with close connections to government and the resources to contract middlemen to unravel the complexities of the administrative system.

In sum, Indonesia's economic and political system is geared towards protecting "insiders" against competition from "outsiders." Large firms are protected from competition by an elaborate system of licenses and close links to politicians and state agencies. Dysfunctional legal and judicial systems are another obstacle to enterprise establishment, growth and formalization. Formal sector workers are protected from competition from the rest of the population by restrictive labor laws. The result is an increasing gap between the insiders and outsiders, the haves and have nots.

Protecting insiders may be a good short term political strategy, but it imposes huge long term costs on the Indonesian economy. If Indonesia is to compete in globalized markets, firms must learn to be more nimble, innovative and responsive to opportunities as they arise. Incumbent firms must be less dependent on government protection, and barriers to entry must fall to allow for the formation of new, dynamic firms. Barriers to job growth and formalization of small businesses must also be eliminated.

William Baumol and his colleagues have identified four elements of a successful entrepreneurial economy (Baumol, Litan and Schramm 2007, 7). These are: i) it must be easy to form a business, hire and fire people, get access to credit, and declare bankruptcy if an enterprise fails; ii) property and contract rights must be secure; iii) government must discourage activities that aim to divide up the economic pie rather than make it bigger and iv) even big firms must be forced to innovate because they are subject to competition through a combination of trade openness and anti-trust policies. Indonesia scores poorly on all four of these criteria. The result is an "insider-outsider" game that widens the gap between rich and poor and undermines the country's competitiveness. The challenge for the future is to transform the rules of the game to build a competitive, entrepreneurial economy, and in doing so recover the missing middle in the country's social, economic and industrial structure.

More opportunities for people to find work and to set up businesses are an important factor in increasing social mobility. Also essential is rebuilding the primary and secondary education systems to provide a high quality education to all children regardless of location, income and gender, and ensuring that access to higher education is based on merit. However, for a sizeable proportion of the population, work and enterprise are not realistic options. Indonesia has sufficient resources to establish pension programs to break the relationship between old age and poverty, and to help elderly people contribute to their families and households. Government neglect of people with disabilities must cease, and the rights of the disabled must be protected in law and in practice.

Indonesia's missing middle has important political as well as economic implications. The existing middle classes are not only small in numerical terms, but they are also closely tied to the state. Outside of Jakarta, the bulk of middle class households includes at least one government official or is linked in some way to government contractors. Indonesian society will not be in a position to discipline government until a larger share of the population has the economic independence, education and confidence to challenge authority structures and arbitrary bureaucratic rule. Deconcentration of power is the essential starting point of institutional transformation. And as long as "outsiders" are kept at bay, the vast majority of Indonesians will not have a stake in democracy and in the country's political stability.

Conclusions

The achievements of the *reformasi* era are important and lasting. Indonesia's political system is democratic, civil liberties have been restored and power has been decentralized to the regions. Aceh is at peace after 29 years of armed conflict. These gains are particularly impressive given the economic, social and political chaos from 1997 to 1999. Some observers predicted a collapse of the central state and some the end of the Indonesian nation itself. The downfall of the New Order was agonizing, but Indonesia has managed to turn the page.

Nevertheless, the legacies of the New Order and Guided Democracy periods continue to weigh heavily on Indonesian economic, political and social institutions. Forty years of institutional history cannot be erased overnight. The main argument of this book is that *reformasi* must move beyond changes to the formal set up of its institutions to undertake a substantive institutional transformation. This will undoubtedly take time. But, if we are correct, time is one thing that Indonesia does not have in abundance. The world is changing, and while Indonesia deals with its political and institutional legacy, the rest of the world is rewriting the rules of production and trade. Globalization presents tremendous opportunities for trade, technological deepening and economic growth. But it is less kind to countries that engage in partial and hesitant economic integration. Indonesia needs to transform its institutions in a hurry to make the most of globalization and to avoid the pitfalls of heavy dependence on natural resources and low-wage manufacturing.

Summary

We began this book with a discussion of the impact of the globalization of production and trade over the past two decades. Digitization, lower transport and communication costs and advances in production technology have revolutionized manufacturing, which is increasingly divided up into discrete steps carried out in numerous and often distant locations. Vertical integration no longer takes place in one location or even in one firm, but instead is led by large multinational system integrators. Boundaries between firms have become blurred as system integrators take greater direct control over their suppliers' production processes. Costs are compressed through intensified competition at every stage of production, which makes it more difficult for new firms to enter at equivalent levels of efficiency. However, modularization does create new opportunities for developing countries to insert themselves into global supply chains, as system integrators are willing to share technology and support capacity development of new suppliers. Encouraging foreign direct investment in strategic industries is the most reliable means of gaining a foothold in these supply chains.

China's phenomenal economic growth also presents challenges and opportunities to countries in the region. China has emerged as the world's assembler, importing components from the rest of Asia and exporting final products to western markets. Indonesia currently runs a trade deficit with China, exporting raw materials and importing manufactured goods. Although pressure is rising from domestic producers to protect Indonesian markets from Chinese imports, this would harm Indonesia in the long run. Indonesian companies must learn how to compete with China in some products and integrate into China-based supply chains in others.

Although Indonesia has posted respectable growth rates during the recent global crisis, from a long term perspective the country is becoming less competitive. Indonesia is changing, but most of the dynamic economies of East Asia are changing faster. Indonesia is losing ground to China, India, Thailand, Malaysia, Vietnam and the Philippines in foreign direct investment flows, manufacturing, infrastructure and education. Indonesia's social indicators are also lagging other middle income countries.

Domestic consumption and high commodity prices are not adequate foundations on which to build an upper middle income economy. Indonesia gets low marks for technological readiness, infrastructure, health and primary education, higher education and training and labor market efficiency. Growth in manufactured exports has been slow in comparison with neighboring countries. Indonesia is competitive in natural resources, but not in manufactures. Indonesia has not succeeded in linking up with Chinese supply chains like Thailand, Malaysia and the Philippines. Over-reliance on natural resources limits productivity growth and job creation, and leaves the country susceptible to unpredictable price swings on global markets.

Foreign direct investment into Indonesia is concentrated in natural resource exploitation and the production of consumer goods for the domestic market. Indonesia's involvement in the production of information technology and telecommunications components is still limited. Foreign investors are put off by the poor quality of the country's infrastructure, notably roads, ports and power. Per capita availability of power in Indonesia is less than Vietnam. The power problem will not be solved until subsidies are reduced, because at the moment increasing the supply of electricity imposes a massive cost burden on government. The government must strike a deal with the public to raise the cost of power in exchange for a more reliable service. The money now used for subsidies should be freed up for more electricity, roads, education and health.

Lack of competitiveness and overly restrictive labor regulations have slowed the rate of job creation, which has the effect of increasing poverty and inequality. Indonesia's social indicators are also falling behind neighboring countries. An Indonesian child is now nearly three times as likely to die before his or her fifth birthday as a Vietnamese child. Progress in providing access to clean water and sanitation has been slow. Nearly one third of children suffer from moderate to severe stunting, and nearly one fifth are underweight. Mothers in Indonesia are more than three times more likely to die in childbirth than Vietnamese mothers.

Nevertheless, Indonesia is often seen as a "pro-poor growth" success story. Measured poverty fell sharply from 1970 to 1996 while the official measures of inequality have remained relatively constant. However, these figures are open to question. Consumption surveys systematically undercount the rich, and the problem appears to be growing worse over time. Indonesia's official poverty line is one of the lowest in the region. Increasing the poverty line by one-fourth would result in a jump in poverty from 18 to 53 percent.

What does Indonesia need to do to improve economic performance and lift more of its citizens out of poverty? One of the main messages of the book is that the government does too many unproductive things and fails to act when it should. The country has squandered its natural heritage by allowing destruction of its forests to continue unchecked. At the same time, Indonesia has underinvested in health and education. The government over-regulates the economy, operating a "license *kerajaan*" analogous to the License Raj of pre-reform India. Over-regulation protects incumbent large firms and penalizes start-ups and small companies. It also forces millions of small and medium scale companies into the informal sector. The resulting industrial structure is dominated by a few huge companies resting on top of a sea of microenterprises. The "missing middle" phenomenon is a symptom of weak legal and regulatory institutions, inadequate protection of property rights and corrupt courts.

Improving the quality of Indonesian government institutions will not be easy. Democracy has not eliminated corruption or strengthened the rule of law. The economic oligarchy has survived the crisis intact, and its relationship to the state is largely unchanged. The institutional legacy of the Guided Democracy and New Order periods continues to weigh heavily on the *reformasi* era. Even the social sciences have not yet been able to shake off habits developed over forty years of authoritarian rule.

We have emphasized five aspects of the institutional legacy of Guided Democracy and the New Order: military versus civilian rule; integration versus decentralization; the "floating mass" versus democratic participation; rule by law versus rule of law; and patrimonialism versus institutional development. Indonesia must arrive at a fuller understanding of these legacies before the country can begin to reform its public institutions. Another essential element of reform is the reconstruction of Indonesian citizenship, by which we mean a renegotiation of the relationship between citizens and the state. The state must be transformed from a vehicle that provides favors and facilities to the rich and powerful, and into a "rule of law" state that works to realize the rights of all citizens regardless of income, region, gender, ethnicity or religion.

Institutional transformation is a long term project. The book concludes with a discussion of several modest measures to help propel the process forward. These include electoral reform, using international standards for some economic institutions, improving the implementation of the decentralization policy and giving more Indonesians a stake in stability and democracy.

Recommendations for further research

This strategic assessment has addressed a wide range of issues in Indonesia's political economy. We have raised more questions than we could answer, and many of our conclusions remain tentative. Indeed, our main motivation in writing it was to provide a framework for future research relating to the country's institutions and institutional change. We hope that our analysis has been sufficiently thought provoking to motivate social scientists in Indonesia and abroad to take up some of themes that we have discussed.

We propose a preliminary grouping of the issues that warrant further investigation into four broad categories: i) institutional transformation; ii) opportunities and challenges of globalization; iii) equity and opportunity, and iv) reconstructing citizenship. Without attempting to prioritize, some of the issues that could be addressed under these headings include the following:

Institutional transformation: an assessment of legal and judicial reform efforts during *reformasi*; a comparative analysis of legal and judicial reform in Indonesia and other middle income countries; a political history of the Corruption Eradication Commission; incentive structures and electoral reform; comparative analysis of public finance for regional government in the ASEAN countries; the political and economic impact of the military's territorial command structure; financing the military under *reformas*i and protecting the forest and people's livelihoods under decentralization.

Opportunities and challenges of globalization: Energy policy; Indonesia's climate change policy after Copenhagen; modularized manufacturing and Indonesia's foreign investment policies; technology and higher education policy for a changing world; Indonesia's automobile parts industry in comparative perspective; costs and benefits of the China-ASEAN free trade agreement for Indonesia; a reassessment of financial liberalization in Indonesia and implications for policy; institutional outsourcing and Indonesia's state-owned enterprises and changing structures and methods in East Asian agribusiness.

Equity and opportunity: Lowering barriers to business establishment, formalization and growth; concentration in the banking system and access of small and medium scale industries to finance in Indonesia; the impact of Indonesia's labor laws on the poor; mobile people and the measurement of poverty and inequality; an assessment of the role of cash transfers in Indonesia's approach to poverty reduction; a comparative assessment of public health policies in the ASEAN countries; strategies to improve education quality and accessibility and the social and political role of middle classes in Indonesia and other ASEAN countries.

Reconstructing citizenship: Access to justice of vulnerable communities; a history of civil and human rights in Indonesia; models of truth and reconciliation and their relevance to Indonesia; teaching Indonesia's modern history to a new generation of citizens; a critical reassessment of the experience of parliamentary democracy in the 1950s; the rights of ethnic and religious minorities in Indonesia in theory and practice and political gangsterism in Indonesia, Thailand and the Philippines.

This is obviously not an exhaustive list, and readers will have reached their own conclusions as to the issues that should be tackled first. Nor are these categories mutually exclusive: work on institutional transformation, for example, is directly related to globalization, social change and citizenship. What is most important is that a body of social science research emerges over the coming years that is able to move beyond the Guided Democracy and New Order legacy to offer a rigorous and impartial assessment of the country's challenges and opportunities as it transforms its domestic institutions and adapts to a changing world.

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Rates of economic growth in Indonesia have returned to the levels experienced before the global economic crisis that started in 2007. And yet other countries in Asia, such as China, India, Thailand, Malaysia, and the Philippines have been growing even faster. Compared to these countries, Indonesia is quickly being left behind in terms of foreign direct investment, manufacturing growth, infrastructure investments, and educational attainment. Like a marathoner carrying a twenty kilogram pack, Indonesia can see the competition pulling away but is powerless to pick up the pace. Indonesia must engage in a thorough process of institutional transformation if it is to shed the legacy of Guided Democracy and the New Order and learn to compete in an ever globalizing economy.

"This book provides a hard-nosed but sympathetic assessment of the achievements, but also the enormous challenges which Indonesia faces in sustaining its economic growth, reducing its poverty, and building the institutions to make it a modern and inclusive democracy. This book should be read by anyone concerned with Indonesia's future in a highly competitive, rapidly globalizing world."

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