BTI 2008 | Indonesia Country Report

Status Index	1-10	**6.17**	**#** 48 of 125	
Democracy	1-10	6.45	# 54 of 125	➔
Market Economy	1-10	5.89	# 57 of 125	➔
Management Index	1-10	**5.27**	**#** 54 of 125	
scale: 1 (lowest) to 10 (highest)		score	rank	trend

This report is part of the Bertelsmann Transformation Index (BTI) 2008. The BTI is a global ranking of transition processes in which the state of democracy and market economic systems as well as the quality of political management in 125 transformation and developing countries are evaluated.

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Key Indicators

Population	mn.	**220.6**	HDI	**0.71**	GDP p.c.	$	**3,419**
Pop. growth[1]	% p.a.	**1.4**	HDI rank of 177	**108**	Gini Index		**34.3**
Life expectancy	years	**68**	UN Education Index	**0.83**	Poverty[3]	%	**52.4**
Urban population	%	**48.1**	Gender equality[2]	**-**	Aid per capita	$	**11.5**

Sources: UNDP, Human Development Report 2006 | The World Bank, World Development Indicators 2007 | OECD Development Assistance Committee 2006. Footnotes: (1) Average annual growth rate 1990-2005. (2) Gender Empowerment Measure (GEM). (3) Percentage of population living on less than $2 a day.

Executive Summary

The successes of Indonesia's largely free, fair and peaceful legislative elections, and the first-ever direct presidential elections, have to be considered important steps toward the consolidation of democratic institutions and processes in Indonesia. However, while electoral democratic institutions seem to be working in Indonesia, the political system is still constrained by a high level of corruption, patronage politics and other informal institutions. Reserved seats for unelected representatives of the armed forces (TNI) and the police (Polri), a relic of authoritarian rule, have not existed since the 2004 polls. While the possibility of a military putsch cannot be discounted, the danger of a coup d'etat is low.

Regular media reports of arrests of corrupt officials provide some evidence that the government has become more serious about tackling corruption and graft. Indonesia is only one of five countries in Asia to have ratified the UN Convention against Corruption to date, suggesting at least the government's determination in the region to tackle corruption. The institutional framework to combat corruption – the Anti-Corruption Commission (KPK) and the Corruption Court, as well as the amendment of laws and new regulations – has improved. In some high-profile cases, senior officials, including the chairman of the General Election Commission, Nazaruddin Sjamsuddin, were sentenced for corruption. However, corruption is still endemic, and despite recent court cases, high-ranking officeholders are still able to escape prosecution. With a score of 2.4 in the Transparency International Corruption Perception Index 2006, Indonesia is one of the most corrupt states in Asia (ranked 20th out of 25) and the world (ranked 130th out of 163).

The results of the 2004 legislative elections show that, while the party system is still unstable overall, Golkar, the former state party, and the Indonesian Democratic Party of Struggle (PDI-P), have established themselves as the main political forces. The

degree of fragmentation makes it difficult for presidents to maintain stable coalitions for the duration of their terms. Political fragmentation in parliament has triggered calls for the streamlining of Indonesia's party system.

During the assessment period, the impact of religious dogmas and conservative Islamic groups on politics or law has grown. The Muhammadiyah movement, founded on modernist Islamic teaching, has veered sharply toward a more conservative brand of Islam, and there are currently over 20 regencies across Indonesia that have issued Shari'ah-influenced bylaws. Nahdlatul Ulama (the biggest Islamic organization in the country) has shown a similar move towards more conservative positions, as illustrated by their strong support of Shari'ah-based bylaws in some areas in East Java, which is the organization's major stronghold. The independence of the judicial branch has grown through transformation, and it is no longer directly dependent on the government's interests. At the same time, the judicial system is considered to be the most corrupt in Southeast Asia. While the military claims that it is no longer a political player, the armed forces' influence over the judicial branch persists. Acquittals of high-ranking officials accused of human rights abuses are the norm.

The degree of stateness significantly increased in Aceh. A peace agreement between the Indonesian government and the Free Aceh Movement (GAM) was concluded in August 2005 in Helsinki. The agreement paved the way for the new Law on the Governing of Aceh, which grants Aceh limited autonomy in political, economic, cultural and judicial areas. In December 2006, Aceh held its first direct elections for key officials, a landmark vote intended to cement the peace deal.

Economic transformation, which was begun two decades ago and preceded political transformation, has yet to yield a free market economy in all key areas. Social exclusion has slightly decreased over the past ten years. The severe economic crisis of 1997 and 1998 affected all social groups and tended to reduce differences in income rather than aggravate them. The Gini ratio was 34.2 in the pre-crisis year of 1996, decreased to 33.3 in 2000, and further to 31.6 in 2003 (latest available data). Property rights acquisitions are formally defined by law, but at the same time, they are subject to informal acts of cronyism, corruption and state intervention. Court rulings can be arbitrary and inconsistent and do not provide adequate legal recourse for settling property disputes.

During the assessment period, continued macroeconomic stability and a stronger international economy have supported renewed growth in Indonesia, and have helped reduce poverty. The 1997 crisis, which rendered many banks insolvent, can be attributed in large part to the absence of effective regulations and supervision of the banking system and the capital market. However, Indonesia's banking industry has been showing signs of recovery since 2003. The government has taken steps toward returning nationalized banks to the private sector and reducing the number of ailing financial institutions that remain in government hands. However, four state-owned

banks continue to dominate the sector with approximately 40% of assets. While a culture favoring stability policies has gradually emerged, institutional safeguards need to be strengthened to reduce the risk of populist policy backlashes. Structural and institutional shortcomings, ranging from infrastructure shortfalls, legal uncertainties and corruption, and labor market rigidities, continue to undermine Indonesia's creditworthiness. The state bureaucracy is inefficient because funding is inadequate, civil servants are poorly trained, laws are sometimes contradictory and corruption remains pervasive. At the municipal level, clear boundaries must still be set for transparent planning and execution.

History and Characteristics of Transformation

Democratic transformation began with elections in June 1999, which followed both the fall of President Suharto, who had led the nation with an iron fist since 1966 with the motto "New Order," and the interim presidency of BJ Habibie. Megawati Sukarnoputri's Indonesian Democratic Party–Struggle (PDI–P) emerged victorious from the first parliamentary elections with 35% of the votes. In October 1999, the People's Assembly (Majlis Permusyawaratan Rakyat, MPR) elected Wahid (Gus Dur) president and Megawati Sukarnoputri vice president, drawing much criticism from politicians and the public. As a result, the constitution of 1945 was amended in 2002 to allow a direct election of the present president for a five-year term.

An impeachment trial against Gus Dur led to his removal from office in July 2002, and Megawati was elevated to the office of president, which she held for two years. Megawati was defeated in the second round of the first direct presidential elections in September 2004 by Susilo Bambang Yudhoyono, who received 60.9% of the vote in a landslide victory. Indonesia's sixth president is a retired general from the armed forces' (Tentara Nasional Indonesia, TNI) "reformist" wing and has not been involved in any human rights violations in East Timor and elsewhere under the New Order regime. His comfortable majority means that he has a strong popular mandate, but his Democrat Party is only the fourth largest party in the House of Representatives (DPR), having won just 56 of 550 seats in the parliament. The second parliamentary elections of the post-Suharto era in May 2004, described by European Union monitors and most other observers as having "credibility and integrity," have strengthened Indonesia's democracy. At the same time, the polls produced a fragmented vote.

In the course of the democratization process, the DPR, which under Suharto was nothing more than a lackey of the administration, was able to establish itself over time as an effective monitoring body for the executive branch. Since 2002, constitutional amendments and reforms have significantly strengthened the power of the legislature. In particular, the role of the military has been reduced. A crucial constitutional

amendment came into effect with the 2004 general elections and terminated the practice of reserved seats for TNI in the unicameral DPR five years sooner than originally planned.

For the first time, all seats in the parliament were contested. Furthermore, at a special meeting in April 2002, some 150 top TNI leaders decided that the military should begin to cease its involvement in political affairs and focus instead on its external defense role. However, TNI has not yet surrendered its self-proclaimed traditional role as a domestic stabilizer of last resort. The military remains the main veto actor, and the threat of a coup d'état still exists, although it became less likely during the assessment period. It is important to note that all main political actors have accepted elections as the only "game in town" and no actors – the president, the military or even militants – have seriously threatened to prevent the scheduled 2004 elections. However, some serious challenges on the road to democratization persist. They include ethnic and faith-based violence in several parts of the country, to which thousands have fallen victim since 1998; regional independence movements; a lack of rule of law and inefficient administration; the continued existence of patronage-based networks; and, more recently, the growing political influence of conservative Islamic groups.

Economic transformation began in the late 1960s, and was the result of a modified economic policy following the change in leadership from Sukarno to Suharto in 1965 – 1966. Indonesia owes its ascent from one of the world's poorest countries to a lower-middle income country to three factors in particular. First, the Suharto regime brought an end to the international isolation under Sukarno, and thus opened up the country to a massive influx of development aid. Second, the explosive growth in oil prices brought rapid economic growth, resulting in an increase in GDP of about 8% per year. Third, Suharto established an authoritarian regime with military support, which eventually developed labor-intensive industrialization with firm control over labor movements. Thus, rapid industrialization occurred at the expense of human rights and democracy. Up until the early 1980s, Indonesia usually enjoyed a balanced budget, and sometimes even a small surplus. The dominant position of state authorities as actors in the development process was characteristic of the boom times of the 1970s. Economic success during this neo-statist period also helped create the breeding ground for the development of an inefficient and corrupt bureaucracy. As a result of an oil shock, the Indonesian economy showed its first signs of weakening in 1982, which intensified rapidly in the subsequent three years. Indonesia had to dedicate 8.1% of its export revenues to debt service in 1980; by 1985, debt service had exploded to 37.3%.

The Suharto administration's reaction to the crisis, which was largely a result of the country's major dependence on the oil trade, was the introduction of a comprehensive national diversification program. The first attempts at fiscal and financial policy reform from 1983 to 1986 were followed by a series of deregulation measures between 1986 and 1990. The modification concept included, among other policies, dismantling trade barriers, reducing the control elements of a planned economy, strengthening the private

sector's role in the development process, devaluating the rupiah (twice), direct investment of profits from the oil business in under-performing trade sectors, and state subsidies for non-oil exports. The reforms made an impact in the first half of the 1990s in the form of GDP growth of 7% to 9%, widespread welfare improvements, and a significant reduction in poverty.

Poverty in Indonesia has been falling steadily since the post-crisis level of 23.4% in 1999. In 2004, the official poverty incidence level was just 16.7%. However, 16.7% of Indonesia's population is more than 36 million people, a significant number by any standard. In 2004, the average national poverty threshold was 122,775 rupiah per person per month (approximately $13.73). Indonesia's poor continue to be concentrated in rural areas (the rural poverty count was 20.1% in 2004). However, Indonesia is undergoing rapid urbanization. In 2000, about 42% of Indonesians lived in urban areas. It should be mentioned that there is controversy surrounding the accuracy of the poverty data. While the presidential palace (based on data published by the National Development Planning Agency Bappenas) estimates that about 30 million of the population live under poverty conditions; other Indonesian institutions (especially NGOs) estimate that more than 70 million people are currently living in poverty. The 1997–1998 Asian crisis hit Indonesia the hardest, causing its GDP to shrink by almost 14% in 1998. The country regressed to the economic development level of the mid-1970s as the economic sector's structural weaknesses, which had been disguised by the preceding boom phase, were exposed. During Suharto's almost 30 years of essentially sultanic rule, improper network relationships emerged between the president's family, the military bureaucracy, major corporations and the country's banks. The economic process functioned through processes that lacked transparency and monitoring by independent actors. Under the strict supervision of the IMF, the administrations of the post-Suharto era (starting in 1998) have made an effort to reform the economic sector drastically. President Megawati is credited with stabilizing Indonesia's volatile post-1997 economy. However, she has failed to rein in what is widely seen as a corrupt elite whose unchecked self-interest has sapped the economy and stunted political development.

The conclusion of Indonesia's five-year IMF program at the end of 2003 did not result in the calamities that some economists had predicted. The government has maintained fundamentally sound macroeconomic policies previously established under IMF guidelines. The Yudhoyono administration has identified infrastructure and the fight against graft and corruption as priority areas. In 2005, the Indonesian economy finally returned to a pre-1997 crisis level of real GDP.

Transformation Status

I. Democracy

Indonesia's legislative elections on 5 April 2004 were "the world's largest and most complex election ever held on a single day" (European Union Election Observation Mission to Indonesia 2004, Final Report), followed by two rounds (July 5 and September 20) of the country's first-ever direct elections of a president. The success of the largely free, fair and transparent elections has to be considered a milestone in the consolidation of democratic institutions and processes in Indonesia. As the EU Election Observation Mission notes, "the peaceful atmosphere and the first ever successful transition of power from a democratically elected administration to another were historic." Both elections have brought incremental, rather than seismic, change to the country's democratic system. However, while the electoral institutions of democracy seem to be working in Indonesia, the political system is still constrained by a high level of corruption, patronage politics and other informal institutions.

1 | Stateness

Monopoly on the use of force

The nationwide implementation of the state's monopoly on the use of force has been one of the greatest challenges in the nation-building process since the country achieved independence. While the state has a monopoly on the use of force on the main island of Java, where about 80% of the population lives, it does so only conditionally in some provinces, particularly in West Papua, where separatist movements have been active for decades. Ethnic conflicts in parts of Kalimantan and religious-based conflicts in Sulawesi keep the state from exercising a full monopoly on the use of force in these areas. Parts of Kalimantan, which faces ethnic conflicts, and Sulawesi, a site of religiously motivated conflict, the state monopoly on the use of force also works only to a certain degree.

In Aceh, which has been struggling for autonomy since Dutch colonial rule, the degree of stateness increased during the assessment period. This northern province of Sumatra, one of the oldest premodern states in Southeast Asia, was governed by a succession of sultans prior to their defeat in 1903 by the Dutch colonial government. The current separatist conflict, led by the Free Aceh

Movement (GAM), is in part an economic conflict as Aceh is one of Indonesia's most resource-rich but nonetheless poorest regions. In 1976, Suharto put Aceh under military rule in an effort to defeat the separatist GAM. Since then, some 6,000 people have died in the conflict, many of them civilian victims of the military. Aceh was under martial law on 26 December 2004, when the tsunami hit the coast. More than 170,000 people were killed and some 500,000 left homeless. At least 50,000 tsunami survivors are still living in temporary housing and half of the province's population is without work. Though various past attempts to conduct peace negotiations had failed, once assuming office, President Yudhoyono immediately initiated a new initiative to bring peace to Aceh. Talks in August 2005 in Helsinki concluded successfully with the signing of a memorandum of understanding between the Indonesian government and GAM. The agreement paved the way for the new Law on the Governing of Aceh, which grants Aceh limited autonomy in political, economic, cultural and judicial areas. One the most important provisions is Aceh's entitlement to retain 70% of oil and gas revenues and other natural resources in its territory and surrounding waters. The province also received a new name: Nanggroe Aceh Darussalam (NAD).

In December 2006, NAD held its first direct elections for key officials, a landmark vote intended to cement the peace deal. In a landslide vote, Irwandi Yusuf, a former member of GAM's military wing who was once jailed for treason, won the governorship. While suspicions remain that Irwandi and his followers will not remain committed to abandoning the goal of independence, the government in Jakarta announced that it is willing to work with the former rebel. Elections for the provincial legislature are scheduled for 2009. Irwandi faces mounting challenges in driving forward a stalled reconstruction process rife with corruption, reintegrating former combatants amid reports that some have turned to crime due to a lack of jobs, and ensuring that aid is distributed fairly between different population groups, particularly between the competing needs of conflict victims and tsunami victims.

State identity

One of the state's outstanding achievements has been to achieve equal rights for all citizens in a nation that is extremely heterogeneous, both in terms of ethnicity and religion. However, during Suharto's New Order era, this equality was true only to a limited degree for the ethnic Chinese (about 3% of the population), whose rights were limited by various laws. It was not until late 2000 that approximately 140,000 ethnic Chinese were finally granted Indonesian citizenship, after some of them had lived as stateless individuals in Indonesia for more than four decades due to discriminatory citizenship laws. The frequently informal discrimination against this minority continues in the state administration's recruitment procedures and in the military, from which they are almost entirely excluded. When it comes to public schools and universities, the ethnic Chinese minority is subject to negative quotas. Secessionist movements

and ethnic or religious conflicts in Aceh, Kalimantan, Papua, Sulawesi and the Moluccas have led individual population groups to question whether they qualify as citizens of the state.

No interference of religious dogmas

The separation of church and state, central to the Pancasila state ideology, is a major supporting pillar of the Indonesian nation as a secular state. At the same time, Islamic groups are politically influential, based on the sheer numbers of their membership – the two largest groups, Nahdlatul Ulama and Muhammadiyah, have more than 60 million members. Some 184 million Indonesians classify themselves as Muslims. Neither the democratic elections of June 1999 nor of April 2004 have led to Islamicization or religious radicalization of Indonesian politics. In 2004, nationalist and moderate Muslim parties won two-thirds of the vote; radicals received only 10%. This said, the elections also produced a fragmented vote which, combined with Indonesia's complex electoral and party systems, has opened a window of opportunity for extremists to advance their agendas. Though radical political groups are small in number, they are believed to be well organized and well funded. During the assessment period, the impact of religious dogmas on politics or law has grown. The Muhammadiyah movement, founded on modernist Islamic teaching, has veered sharply toward a more conservative brand of Islam under the leadership of Din Syamsuddin, who is also head of Indonesia's Council of Ulama, which has issued edicts banning Islamic interpretations based on liberalism, secularism and pluralism. There are currently over 20 regencies across Indonesia that have issued Shari'ah-influenced bylaws. The regency of Bulukumba in South Sulawesi, for example, has issued bylaws obliging women to wear Islamic attire, requiring couples wanting to get married to be Quran-literate, and compelling residents to pay zakat, or religious tithes. The authorities in Bulukumba's Padang village have used flogging as a method of punishment for those found violating Islamic principles. In the regency of Pandeglang, schools are forced to provide separate classes for boys and girls. Tangerang city's anti-prostitution bylaw prevents women from going out at night and otherwise "acting suspiciously." Pasuruan (East Java) and Bogor (West Java) have issued laws requiring restaurants and food stalls to be closed at daytime during the entire fasting month of Ramadan. Many secular politicians and non-state actors have criticized the attempts to formalize Shari'ah-based laws as undermining democratic values and Indonesia's culture of pluralism. Former President Abdurrahman Wahid called the laws an attack on the Indonesian Constitution of 1945, which guarantees civil rights and recognizes the diversity of the Indonesian people.

Basic administration

The state's fundamental infrastructure extends throughout the entire territory of the country (administrative institutions, officeholders, fundamental administration of justice, making and implementing political decisions), but its operation is to some extent deficient, particularly with regard to the administration of justice and

the efficiency of implementing political decisions. The ongoing process of decentralization represents the most decisive transformation of the administrative infrastructure in Indonesia's history. Central civil servants were transferred to other locations, over 16,000 public service facilities were handed over to the regions, and a new intergovernmental fiscal system was put in place. Most government services have not been interrupted following the handover of administrative authorities. However, decentralization has expanded the power of local officials without improving their oversight. Furthermore, the central government has reclaimed some district or regency powers with the help of an amendment to the law on decentralization that was completed at the end of Megawati's presidency. This indicates Indonesian government's ambivalence toward decentralization. The World Bank nevertheless expects Indonesia to become one of the most decentralized states in the world, much more decentralized than otherwise expected given the country's structural characteristics.

2 | Political Participation

Free and fair elections

Elections are held every five years. Indonesia's parliament consists of the House of Representatives (Dewan Perwakilan Rakyat, DPR) and the People's Consultative Assembly (Majelis Permusyawaratan Rakyat, MPR). The MPR meets every five years to approve the broad outlines of national policy and meets annually to consider constitutional and legislative changes, but does not formulate national policy. The DPR's 550 members automatically become members of the MPR, which also includes the regional delegates of the Regional Representative Council (Dewan Perwakilan Daerah, DPD). While DPD members are elected on a constituency basis, DPR members are elected on the basis of party lists. It should be noted that the DPD is not an upper house in a bicameral parliament. The DPD's powers are limited to submitting bills to the DPR and giving advice to the DPR on important matters, as indicated in an amendment to the 1945 constitution. However, there is a growing demand from the DPD for more power and a more prominent role in the process of lawmaking. This should be read as a signal for demanding change, namely to transform the the parliament into a bicameral system. The majority of Indonesia's state and civic actors believe that, since the first president of the democratic era, Adburrahman Wahid, was not elected directly, this represents a significant restriction of the voters' will. As a result, new electoral laws were passed by the DPR in July 2003, which, in addition to laying down the composition of both houses of the legislature and of provincial legislatures, paved the way for the first direct elections of the president and vice president in 2004. However, the nominations for presidential tickets can only be made by parties that receive either 3% of seats in the DPR or 5% of the overall vote. General elections are held, and they are accepted, in principle, as the

appropriate means of filling leadership positions. Both the legislative and presidential elections of 2004 were conducted largely in line with democratic standards. There have been no reserved seats for unelected representatives of the armed forces (TNI) and the police (Polri) since the 2004 elections, which is a relic of authoritarian rule. Nevertheless, there were significant constraints on political party registration and electoral participation in the 2004 elections: universal suffrage was not implemented fully, TNI and Polri members did not have the right to vote, and former members of the Indonesian Communist Party (PKI) were not allowed to campaign for elections. The EU monitoring mission described the local elections in Aceh in December 2006 as a smooth ballot and praised the population's calm behavior, despite the numerous logistical difficulties in a region still scarred by the tsunami.

Effective power to govern

Elections are now considered by all relevant actors as the accepted method for selecting a leader. However, the armed forces remain powerful veto actors as they reserve the right to interfere with the elected government if they believe the unity and stability of the Indonesian nation to be threatened. The possibility of a military coup cannot be discounted and has not decreased during the period under review. The armed forces' opportunity to seize control lies primarily with the economic success or failure of Indonesia's democratic government. Radical Islamic groups have not been able to establish themselves against the moderate and true-to-the-constitution tenor of the majority of Islamic actors. They have also failed to capitalize on the war on terrorism, into which Indonesia was drawn on 12 October 2002 with the Bali bombing, the subsequent attacks at the Marriot Hotel in Jakarta (August 2003) and the Australian Embassy (September 2004). However, the political influence of conservative Islamic actors has grown during the assessment period. This development is seen by some actors of the moderate and liberal political spectrum as an attempt to undermine Indonesia's democracy.

Association / assembly rights

As part of the gradual conversion to a democracy that has been underway since May 1998, civic groups are now essentially guaranteed unlimited freedom of association and assembly. The same is true for complete press and speech freedoms, which were significantly restricted under Suharto. Under Wahid, Chinese-language media were again allowed, after being banned in the coup attempts and communist hunts of the late 1960s. Further indications of strengthened civil liberties include the revocation of the anti-subversion law, the enactment of a new law on political parties, and a new law guaranteeing freedom of expression and organization, which led to the mushrooming of NGOs, civil society organizations and independent labor unions.

Freedom of expression

Freedom of speech is formally guaranteed in post-Suharto Indonesia. However, as far as the freedom of the press is concerned, among the four governments after Suharto, the government of President Yudhoyono has been the most aggressive in its relations with the media. The current government has, for instance, issued four

presidential regulations and two ministerial decrees affecting the media. According to the World Wide Press Freedom Index, which is published annually by Reporters sans frontières, Indonesia's press freedom level remains fairly low, and has decreased since 2002. The 2006 report ranks Indonesia at 103 out of 168 countries with a score of 26.0 (the lower the score, the higher the press freedom). When the Index was first published in 2002, Indonesia ranked 57th out of 139 countries, with a score of 20.0. The 2006 report goes on at length about the "Muhammad cartoons" issue, claiming that journalists were harassed in Indonesia because of the matter. Of Indonesia's neighbors, Malaysia ranks 92nd, Singapore 146th, Philippines 142nd, Thailand 122nd, and East Timor 83rd.

3 | Rule of Law

Separation of powers

There were no separation of powers in Indonesia until 1998; the DPR, the MPR, and the judiciary acted as dependent subordinate bodies to the executive branch and were linked to it through intricate network relationships. The DPR and the MPR have become increasingly emancipated during transformation. However, the constitution of 1945 is vague in many regards, especially on the role of the legislative branch and the separation of powers. The constitution solidifies the president's strong position. Despite various rounds of amendments, it is still weak in terms of institutional mechanisms of checks and balances. Recent constitutional reforms have significantly strengthened the power of the legislature. But the legislature may not be able to use this power effectively because other reforms have made it easier for smaller political parties to gain seats in the proportionally allocated DPR. In general terms, a party is affiliated with its leader rather than its ideology. When a leader moves away from the political scene, the party loses much of its identity. Hence, the floating identity of political parties makes it difficult to form coalitions along party lines. Recently, signs of overlapping functions in some newly formed judicial institutions, such as between the MK (Constitutional Court) and the KY (Judicial Commission), and between KY and MA (the Supreme Court) have become visible. Most recently, the KY and MA wrangled over the appointment of Supreme Court judges.

Independent judiciary

The independence of the judiciary has grown during transformation, and it is no longer directly dependent on the government's interests. At the same time, the judicial sector is considered to be the most corrupt in Southeast Asia. Systeic corruption in Indonesian courts, including the Supreme Court, has not improved, but has consolidated. The judiciary has regularly been influenced by the military, business interests and politicians outside of the legal system. Bribes have influenced prosecution, conviction, and sentencing in countless civil and criminal cases. Courts also often limit defendants' access to counsel and allow forced confessions to be used as evidence in criminal cases. The judiciary's weakness

has helped perpetuate human rights abuses by the security forces, particularly in Aceh and Papua. Indonesian forces also enjoy near impunity in encounters with ordinary criminal suspects. While TNI claims that it is no longer a political player, the military's influence over the judicial branch persists. Acquittals of high-ranking officials accused of human rights abuses are the norm. A further reason for the judiciary's weakness is Indonesia's adherence to the antiquated Dutch colonial legal code, which significantly restricts the ability of courts to resolve modern conflicts, particularly those pertaining to intellectual property rights (IPR) violations, financial and cyber crimes. Between 1998 and 2001, numerous constitutional changes were approved to create an independent judiciary, but the lack of political will to enact those changes has hindered reforms. A new, and by far the most substantial, attempt to increase the judiciary's independence was made in April 2004 when, for the first time in almost four decades, the Supreme Court was nominally freed from direct government intervention, assuming administrative and financial responsibility for the lower court system from the Ministry of Justice and Human Rights. In 1964, the country's founding President Sukarno placed the entire legal system under his control. A separate Constitutional Court, or Makhama Konstitusi, was established in 2003.

Prosecution of office abuse

Regular media reports of arrests of corrupt officials provided some evidence that the government has become more serious about tackling corruption and graft. Indonesia is only one of five countries in Asia to date (the others are Australia, China, Mongolia and Sri Lanka) to have ratified the UN Convention against Corruption, suggesting that the government is determined to tackle the problem. The institutional framework for battling corruption, including the Anti Corruption Commission (KPK) and the Corruption Court as well as the amendment of laws and new regulations, has improved. In some high profile cases, senior officials, including the chairman of the General Election Commission, Nazaruddin Sjamsuddin, were convicted of corruption. The government has responded to foreign investors' concerns about corruption, as well as bureaucratic and regulatory hindrances. The government's efforts have been slowly paying off, especially in the areas of taxation and customs. A culture of fear of openly engaging in corruption has emerged amid anti-corruption investigations, which have led to several high profile prosecutions, asset recoveries and rising complaints via a whistle-blower program. However, corruption is still endemic, and despite recent court cases, high-ranking officeholders are still able to escape prosecution. With a score of 2.4 in the Transparency International Corruption perception Index 2006, Indonesia is one of the most corrupt states in Asia (ranked at 20 out of 25) and the world (ranked at 130 out of 163). In May 2006, Indonesia's attorney general dropped long-standing corruption charges against Suharto because of his health, angering rights activists but gratifying his supporters, many of whom became rich during his 32-year rule and remain in

powerful positions within the bureaucracy.

Civil rights

Qualitative advances can be observed in the expansion of civil liberties, especially in the repeal of laws from the Suharto period that discriminated against ethnic Chinese and other minorities. Indonesia is evolving into a more open society. The private press, while at times shoddy and sensationalist, reports aggressively on corruption, government policy and other formerly taboo topics. Journalists, however, face some police violence and intimidation, as well as occasional attacks by paid thugs, student activists and religious extremists.

4 | Stability of Democratic Institutions

Performance of democratic institutions

The degree to which democratic institutions perform their functions has improved, but waste still occurs because of friction between institutions, particularly in relations between the executive and legislative. The threat of a military (TNI) infiltration of the democratic institutional structure remains anddid not change during the assessment period. In accordance with the dwi fungsi or double function doctrine, the TNI traditionally considers itself to be not only the guarantor of the country's territorial integrity, but also the guardian of Indonesia's internal order. The high offices that members of the military still occupy at all levels of government and administration are a visible expression of the military's distinguished privileged position in domestic policy.

Commitment to democratic institutions

The elections of 2004 demonstrated that the institutions of the democratic state are accepted by most relevant players, with the notable exception of a small number of radical or fundamentalist splinter groups and secessionist movements. Conservative Islamic groups have so far neither challenged nor threatened existing democratic institutions. In the political context of Indonesia, the vast majority of conservative Muslim politicians are not anti-democratic. Under Suharto, both political liberals and religious leaders were suppressed as threats to the regime, which led to an unusual alliance between human rights advocates and outspoken clerics. Since the onset of democratization, the two groups have regularly found themselves on the same side of political debates in opposition to those survivors of the Suharto regime who resisted change.

5 | Political and Social Integration

Party system

Indonesia is characterized by a fragmented party system comprising two large, five medium-sized and ten smaller parties that are currently represented in the legislature. The degree of fragmentation makes it difficult for presidents to maintain stable coalitions for the duration of their terms. The political fragmentation in parliament has triggered calls to streamline Indonesia's party

system. Some of the large and medium-sized parties have proposed raising the existing electoral threshold from its current level of 3% to 5%, or even 10%. As expected, the smaller parties have opposed these attempts to reduce their influence, and have tried to mobilize civil society groups to defend their cause. In the 2004 DPR elections, the secular-nationalist parties (PDIP, Golkar, PD, PDS and some others) secured 51% of the vote, the Islamist parties (PPP, PKS, PBB, PBR, and some others) secured 20%, and a combination of Islamist and nationalist parties (PKB and PAN) secured 19%. The direct presidential elections gave more incentives for political parties and presidential candidates to form coalitions with other political groups, called aliran. The results of the 2004 parliament elections show that while, on the whole, the party system is unstable, Golkar, the former state party, and the Indonesian Democratic Party of Struggle (PDI-P), have established themselves as the main political forces. The core of the Indonesian party system continues in the transformation phase to be a set of formal and informal institutions that have existed for some three decades and are firmly anchored in society. It is noteworthy that the democratization process underway since 1998 has not led to the Islamicization of the party system. Despite the success in taking part in the two consecutive democratic elections, political parties in Indonesia still depend on patron-client relationships in many respects, especially in mobilizing support, recruitment, political communication and so forth. Within this system of "money politics," it seems to be common for candidates to disburse money to party cadres and functionaries within their clientelist networks. This may explain why corruption scandals (especially those involving party bosses) are rampant and difficult to fight.

Interest groups

Islamic associations are the most significant and best-organized intermediary actors. This is especially true for the umbrella groups Nahdlatul Ulama (NU) and Muhammadiyah, which play significant intermediary roles between society and the political system. They are some of the opinion leaders in the debate about the future relationship between the state and religion. Other actors at the intermediary level, such as trade associations and unions, play a less significant role. Although Indonesia's level of unionization has risen from 1.4% in the mid-1990s to about 9% of the total labor force in 2004, the unionization rate is still among the lowest in Southeast Asia. In 2005, 86 trade unions at the national level were registered with the Department of Manpower, as well as tens of thousands of local and industrial unions. The influence of the Indonesian Chamber of Commerce and Industry, KADIN, on the decision-making processes in economic policy is significant. KADIN unites 27 provincial chambers, 300 on the district level, and more than 200 industry associations under its umbrella, but it mainly represents the interests of the upper middle class and major enterprises. Generally, the intermediary actors do not present an anti-democratic threat.

Consent to democratic norms

Reliable survey data regarding the degree of consent to democracy are not available, but a study by the Asia Society concluded that, "by and large, the general public only has a vague understanding of the concept of democracy. If they have an opinion at all it is broadly in the area of freedom and liberty." For many Indonesians, democracy is merely a simple state of majority rule through a process of voting and elections. For others, democracy comes with upholding the rule of law, protecting civil liberties and the rights of minorities. A growing number of political and civil society actors perceive current attempts to formalize Shari'ah-based laws as a threat to democratic values and Indonesia's culture of pluralism. Overall, the Indonesian democracy is challenged by what Larry Diamond terms "elements of disloyalty" (those actors who strongly oppose and reject democracy) and "semi-disloyalty" (those who are still confused about what democracy is and unsure about whether democracy is the only game in town). While the strongest supporters of democracy may grow over time, the existence of hard-line militarists, religious extremists, and chauvinists can potentially bring democracy to a halt. Even though they are in the minority, their tactic of combining persuasion and violence may be threatening. The presence of semi-disloyal elements, which seem to be significant in number among the poor and the politically ignorant, seems to be a challenge for Indonesia. If the loyalists can bring them into the fold, a consolidation in the country's democracy is possible. Otherwise, if disloyal actors get the upper hand, democratization might reverse back to autocratic rule. Transformation has brought forth a number of new civic actors or self-reliance organizations (lembaga swadaya masyarakat, LSM) in Indonesia, which can be described as a heterogeneous network of autonomous, self-organized groups, associations and organizations.

Associational activities

Indonesian civil society organizations increasingly engender social capital, one of the key assets that can protect the poor and vulnerable from economic shocks. Indonesia has national and local level NGOs, religious organizations, groups that form around common professions (such as motorcycle taxi drivers, or fishermen), and organizations of people from the same geographic area of origin. This latter type of group is found particularly in urban and industrial areas with many migrants. Other civil society groups include those formed around ethnic groups. For example, civil society support for poverty reduction includes advocacy for poverty oriented budget allocations, or funding, designing, implementing, and monitoring poverty reduction initiatives.

II. Market Economy

The transformation of the Indonesian economy began in the early 1980s and preceded the country's political transformation, but has yet to result in a free market economy. The Heritage Foundation's 2007 Index of Economic Freedom classifies the Indonesian economy at 55.1%, which ranks it at 110th in the world's free economies. Its overall score is one percentage point higher than in 2005. Indonesia is ranked 21st out of 30 countries in the Asia-Pacific region, and its overall score is lower than the regional average. Indonesia scores well in fiscal freedom, freedom from government, and labor freedom. Government expenditures are relatively low, and state-owned businesses do not account for a significant portion of total revenues. At the same time, Indonesia is weak in business freedom, investment freedom, financial freedom, property rights, and freedom from corruption. Foreign investment is restricted, and judicial enforcement is both erratic and non-transparent in its treatment of foreigners. Due to rampant corruption, impartial adjudication of cases is not guaranteed.

6 | Level of Socioeconomic Development

Socioeconomic barriers

Overall, social exclusion has slightly decreased over the past ten years. The severe economic crisis of 1997–1998 affected all social groups and tended to reduce differences in income rather than aggravate them. The Gini ratio was 34.2 in the pre-crisis year of 1996 and decreased to 33.3 in 2000 and further to 31.6 in 2003 (latest available data). The national level Gini coefficient is higher than that of most provinces; only three provinces (In descending order: D.I Jogyakarta, Papua, and Banten) have Gini coefficients that are higher than the national average. The HDI value in 2004 was 0.711. However, this masks a considerable variation across the country. There are significant differences between the provinces, from 0.76 in Jakarta to 0.58 in West Nusatenggara. However, there are even greater differences between the districts, whose HDIs range from 0.76 in East Jakarta to 0.47 in the district of Jayawijaya in Papua. The fact that the GDI value in all Indonesian provinces is slightly lower than the HDI rate indicates gender inequality. The gap between GDI and HDI has almost remained constant. Between 1998 and 2004, the GDI increased nationwide from 0.664 to 0.704 in 2004 (the most significant increase has taken place since 2002, when the GDI stood at 0.685), while the HDI value improved from 0.67 to 0.711 during the same time period. The difference between the two ratios increased only insignificantly from 0.006 to 0.007, indicating neither growing nor declining equality in human development achievements between women and men. According to an ADB study of June 2006, there are significant regional

disparities in Indonesia. The provinces with the highest poverty headcounts are not the same as the provinces with the greatest number of poor people. In terms of magnitude, East Java contains the largest number of poor people (about 7.3 million in 2004), but the province's population was below the national average. The less populated eastern provinces have the highest populations, but a far smaller number of poor. Regional disparities can be grouped into three broad categories: those between Java and the rest of Indonesia, those between East and West Indonesia, and those between urban and rural areas of Indonesia.

Economic indicators		2002	2003	2004	**2005**
GDP	$ mn.	200,111	237,417	254,298	**287,217**
Growth of GDP	%	4.4	4.7	5.1	**5.6**
Inflation (CPI)	%	11.9	6.6	6.2	**10.5**
Unemployment	%	9.1	9.5	9.9	**-**
Foreign direct investment	% of GDP	0.1	-0.3	0.8	**1.8**
Export growth	%	-1.2	5.9	13.5	**8.6**
Import growth	%	-4.2	1.6	27.1	**12.3**
Current account balance	$ mn.	7823.5	8106.8	1563.0	**929.3**
Public debt	$ mn.	71,145.1	74,023.5	71,990.6	**72,334.8**
External debt	$ mn.	132,838.9	136,955.5	139,723.1	**138,300.2**
External debt service	% of GNI	8.7	8.1	8.3	**6.5**
Cash surplus or deficit	% of GDP	-0.3	-2.3	-1.1	**-**
Tax Revenue	% of GDP	11.6	12.2	12.5	**-**
Government consumption	% of GDP	7.1	8.0	8.4	**8.2**
Public expnd. on edu.	% of GDP	1.1	1.0	-	**-**
Public expnd. on health	% of GDP	0.9	0.9	1.0	**-**
R&D expenditure	% of GDP	-	-	-	**-**
Military expenditure	% of GDP	1.0	1.1	1.1	**1.2**

Sources: The World Bank, World Development Indicators 2007 | UNESCO Institute for Statistics | Stockholm International Peace Research Institute (SIPRI), Yearbook: Armaments, Disarmament and International Security

7 | Organization of the Market and Competition

Market-based competition

In the 1980s and 1990s, the economy of the New Order regime was characterized by crony capitalism. Yet Indonesia appears to fare little better at the time of this report. Despite the reforms that have been carried out since the mid 1980s to strengthen free market competition, liberalization is being hindered by both formal and informal regulations and processes. Property rights remain largely insecure and contracts cannot be enforced. Legal institutions, procedures and structures are still inadequate to support a modern market economy. Article 33 of the constitution solidifies the primacy of state-owned enterprises over private enterprise and serves as an across-the-board justification for the preferential treatment given to individual actors in the economy. The political will to break up the patronage-based networks that arose between the political elite, the military and large enterprises during the New Order era, and the monopoly creation that went along with them, has been absent so far. Although the new Cartel Act of 1999 is meant to regulate the formation of monopolies and oligopolies, the act contains passages that open the door once again to cronyism, neo-patrimonialism patronage and corruption.

Anti-monopoly policy

On the one hand, overall economic development has significantly improved and the institutional framework has at least changed to the extent that political stability has brought about a higher degree of predictability as far as the framework conditions for a market-based economy are concerned. On the other hand, the institutional framework as such (safeguards of property rights, an independent and non-corrupt judiciary, market-friendly legislation, the abolishment of cartels and monopolies, etc.) has not yet substantially improved. However, the government has already embarked on various initiatives to phase out monopolies by state-owned companies that dominate most key sectors of the economy. For example, in 2005, the government awarded 15 exploration contracts to various domestic and foreign oil companies. Since 2004, the government had invited Petronas (Malaysian oil company), British Petroleum, and Total to open more than 200 new petrol stations across Java island to retail oil. Legislation has been drafted to allow the private sector to take part in the country's railway business, thus ending the monopoly by state-run railway firm PT KAI. Furthermore, plans were unveiled to end the state-owned companies' monopolies in managing ports, airports and railways, in a bid to bring in investors and improve efficiency in these sectors. The phase-out plan is contained in new draft laws on ports, airports and railway.

Liberalization of foreign trade

Until the mid 1980s, Indonesia used licensing to restrict imports to protect nascent industries from competition, thereby providing enormous profits to the licensees and raising input costs for domestic industries. Since 1986, however, the

government has steadily replaced such non-tariff barriers with tariffs and has reduced these tariffs in line with Indonesia's commitments to the International Monetary Fund and as a member of the Association of South-East Asian Nations (ASEAN), the ASEAN Free-Trade Area, the Asia-Pacific Economic Cooperation Forum, and the WTO. However, the WTO considers Indonesian tariffs to be moderately high. The country's average unweighted tariff has stood at around 7% for the past several years, down sharply from 20% in 1994. Roughly 70% of Indonesia's import lines face tariffs of 0-5%. Tariffs on cars, iron, steel and certain chemical products remain unbound. Most other non-food goods have a maximum tariff of 10%. The government has reduced duty rates on many items in recent years in line with obligations to the WTO, including on four controversial items: maize, sugar, soybeans and rice. A prevailing lack of transparency and predictability in granting licenses and in the administrative implementation of trade policy hinder the functionality of the trade regime.

Banking system

The absence of effective regulation and supervision of the banking system and the capital market contributed significantly to the outbreak of a crisis in 1997, which drove many banks to insolvency. The state-run Indonesian Bank Restructuring Agency (IBRA) was put in charge of implementing large-scale reform programs that were intended to stabilize the banking sector. All in all, the IBRA distributed government loans worth $47.78 billion to recapitalize the banks before it closed down its operations in February 2004. Since 2003, Indonesia's banking industry has shown signs of recovery. The government has taken steps towards returning nationalized banks to the private sector and reducing the number of ailing financial institutions that remain in government hands. As a result, the number of licensed banks decreased from a peak of 240 in the mid 1990s to 131 in 2006. Forty-one banks are under the control of foreign investors. The top 10 banks control about 80% of assets in the sector. Four state-owned banks continue to dominate the sector with approximately 40% of assets. Partly supported by a surge in private consumption and a recovery in lending for investment purposes, the banking sector grew strongly in recent years. Banking stocks have been among the best performing on the Jakarta Stock Exchange. At the same time, non-performing loans (NPL) remain high in relation to total loans with national banks reporting a ratio of between 6% and 9% (2006 figures). The government has delayed a plan to privatize PT Bank Negara Indonesia (BNI), one of the oldest and largest banks in the country, due to its high level of NPLs, which are above 10%. The long-proposed Financial Supervisory Agency (FSA) has not yet been established. Bank Indonesia will eventually relinquish its role in bank supervision. In an amendment passed in December 2003, a target date of December of 2010 was set as the latest date for the separation of banking supervision authority from the central bank. By doing so, Indonesia will follow the steps taken by countries such as South Korea and the United Kingdom where the central bank will no longer have any supervisory responsibility.

8 | Currency and Price Stability

Anti-inflation / forex policy

Over the past 15 years, inflation in Indonesia has been consistently higher than elsewhere in the region. Inflation has often exceeded the 7–11% threshold above which it is estimated to adversely affect growth. During this period, the inflation rate has averaged about 12.5%, or 9% higher than in neighboring countries, and has shown significantly higher variance. A World Bank study of September 2006 suggests that the causes of Indonesia's relatively high inflation, as compared with other countries in the region, include various structural factors, such as strong inflation inertia (due to the fact that for most of its history as an independent state Indonesia was confronted with high inflation rates), and political instability, combined with expansionary monetary policy and currency depreciation. The central bank (Bank Indonesia) only recently adopted an inflation targeting strategy. Bank Indonesia achieved the status of an independent state institution in 1999 when the new Central Bank Act was enacted. The central bank is autonomous in formulating and implementing each of its task and authority, as stipulated in the act.

Macrostability

Since 2002, Indonesia has enjoyed increased economic stability as interest rates have declined, the national currency has strengthened and the stock market has climbed. The government has made substantial progress in financial sector reforms. In July 2006, Standard and Poor's (S&P) upgraded Indonesia's long-term foreign currency rating from B+ to BB-. Favorable external conditions and prudent economic reforms have improved Indonesia's creditor status. Sustained current account and fiscal surpluses lowered central government debt to just under 50% of GDP in 2006. This constitutes a remarkable reduction of debt from over 100% of GDP in 2000. While a culture of policy stability has gradually emerged, institutional safeguards need to be strengthened to reduce the risk of populist policy backlashes. Structural and institutional shortcomings, ranging from infrastructure shortfalls, legal uncertainties and corruption and labor market rigidities, continue to undermine Indonesia's creditworthiness.

9 | Private Property

Property rights

Property rights and the regulation of property acquisition are formally defined by law, but at the same time they are subject to informal acts of cronyism and corruption and state intervention. Court rulings can be arbitrary and inconsistent, and the court system does not provide adequate legal recourse for settling property disputes. Despite pressure from the international community on Indonesia to honor internationally binding contracts, the government has suspended various private infrastructure projects for economic and political reasons.

Private enterprise

Indonesia's privatization program was initially part of the reforms mandated by the IMF in the wake of the 1997–1998 Asian financial crisis. Privatization has especially taken place in the sectors of water, energy and health. Meanwhile, Suharto's cronies and the military, which have maintained control over state-owned enterprises and monopolies, continued to dominate strategic economic sectors. While the Wahid administration did not make much headway in the privatization of state-owned enterprises, the successor government of President Megawati made some progress in selling off state-owned banks and companies to comply with the asset sales requirements of the IMF in return for $5.1 billion in loans. The government decided to continue with the program even after the IMF ended its Indonesia mission in 2004, but the process of privatization has been slow since then. Indonesia plans to raise 3.3 trillion rupiah ($357 million) from its privatization of state-owned enterprises in 2007. The process of privatization is usually consistent with market principles but still constrained by corruption and lack of transparency in some cases. Due to the strengthening of market principles and an improved business environment for private companies, Indonesia has seen significant growth in small and medium enterprises (SMEs). There are currently around 40 million SMEs in Indonesia, making up 90% of the country's total companies. SMEs create nearly 37 million jobs and their production contributes 52% to Indonesia's GDP.

10 | Welfare Regime

Social safety nets

The Suharto regime attempted to build up a social network. In the field of health care, for example, a network of local health centers (puskesmas) was built; their quality, however, was low in many cases, and they were not financially accessible to families with low incomes. During the 1990s, Indonesia was one of the worst rated among developing countries in the number of hospital beds per capita. Indonesia also lags behind other countries in Southeast Asia, such as the Philippines and Thailand, when it comes to infant mortality rates. The government has been more successful in fighting poverty in the last two decades, especially as a result of the nutrition policy based on stable prices for staple foods and a massive increase in rice production. Over the past decade, the government has tried somewhat successfully to cushion the effects of the 1997–1998 crisis on the most seriously affected social groups by strengthening social networks (e.g., by setting up the Social Safety Net Scholarship Program).

Equal opportunity

Indonesian society is very heterogeneous in ethnic and religious terms, and it is characterized by a high degree of socioeconomic inequality. While poverty has come down to single digit levels in Jakarta (from 15.5% in 2000) and Bali, it remains as high as 30% or more in Aceh and Maluku, and 42% in Papua. The fact that socioeconomic inequality is not as severe as it was two or three decades ago

is largely due to the success of a long phase of economic growth, combined with the Suharto regime's education offensive, as a result of which virtually all Indonesians are guaranteed access to at least a primary education. However, while continued macroeconomic stability and a stronger international economy have been supporting renewed growth in Indonesia and contributing to a reduction in poverty, more than 100 million Indonesians were surviving on less than $2 a day in 2006, according to the World Bank. Widespread poverty prevents millions of children from getting an education. About 40% of parents cannot afford to send their children to secondary school.

Unequal opportunities based on gender decreased significantly in the 1990s, which can be seen by the improved access for girls and women to education and the labor market. At the same time, the ratio of female earned income to male earned income is still relatively low at 0.51, and Indonesian women are still heavily underrepresented in political life. During the 1999 elections, women made up 57% of the voters. However, women held only 45 (about 9%) of the 500 seats in the national parliament. In 2004, that figure increased to just 11.1%, with 61 women elected. Only 12 sitting female candidates were re-elected. The 2003 electoral reform bill mandated that women must make up 30% of candidates for the 2004 parliamentary elections, but no party achieved this goal. On the local level, the figure of female representation is between 0% and 2%. In Indonesia's paternalistic patriarchal culture, it is still difficult for women to gain access to public office, and there is little political will to introduce comprehensive gender-based reforms. Women in general remain marginalized in various sectors. Not only do they rarely occupy strategic positions in both private and public sectors, but they also hold subordinate positions in most households. On the whole, social networks and institutions meant to equalize glaring social differences are better developed than ever before in the history of Indonesia, but they remain below par in comparison to most other countries in Southeast Asia.

11 | Economic Performance

Output strength

After taking office on 20 October 2004, President Yudhoyono moved quickly to implement a "pro-growth, pro-poor, pro-employment" economic program. In early 2006, the government of Indonesia announced new policy packages for stimulating investment and infrastructure. Indonesia's overall macroeconomic situation is stable and key indicators improved during the assessment period. By 2004, real GDP per capita returned to pre-crisis levels. Inflation has been lowered, the rupiah is stable and interest rates have decreased significantly. The stock market has impressed investors with a 47.6% increase in share prices in 2006, on track for 72% compounded growth for 2005 and 2006. However, the average growth rates since 2004 have been well below the government's targeted

average growth of 6.6% from 2004 to 2009 to reduce unemployment and poverty significantly. Growth is constrained by poor yet slowly improving infrastructure, a high degree of corruption and low levels of investment.

In 2006, FDI declined by 32.9% from $8.915 billion in 2005 to $5.977 billion in 2006. The number of projects in 2006 also fell from 909 to 867 in the previous year. Domestic investment in 2006 dropped by 32.2% to IDR 20.788 trillion, from IDR 30.665 trillion in the corresponding period a year earlier, and the number of projects dropped by 24.4%, from 214 to 164. Indonesia's GDP structure in 2006 consisted of manufacturing (28.89%), services (23.67%), agriculture (13.82%), mining (9.54%) and utilities. The government raised fuel prices by an average of 126% in October 2005 in an effort to reduce Indonesia's fuel subsidy burden, which accounts for 3.3% of GDP. The fuel price hikes led to a surge in inflation as consumer price inflation reached 10.5% for 2005 and an estimated 13.2% for 2006. The unemployment rate in Indonesia reached 10.28% of the labor force, equivalent to 10.9 million people in 2006. The government considers an unemployment rate of above 5% as unmanageable. The economy needs growth of at least 6% to help create 300,000 new jobs a year. However, a combination of problems, ranging from lack of investment, unpredictable legal system, and rampant corruption, to poor human skill, hampered efforts to spur growth.

Natural disasters, mainly the tsunami of 26 December 2004, and the outbreak of avian flu in Indonesia, have taken a toll on the economy, with tourism and the poultry industry suffering millions in losses since 2005. More than 50 people died, making Indonesia the country with the highest human death toll. Two terrorist attacks damaged Bali's economy, and Bali is now reeling from a decline in tourism by as much as 50% because of avian flu.

12 | Sustainability

Environmental policy

Before the economic crisis, the Indonesian government made serious efforts in the area of environmental policy by requiring every construction project to complete an "environmental impact assessment" (Analisa Mengenai Dampak Lingkungan, AMDAL) administered by the Ministry of Environment in cooperation with NGOs. However, since the 1997–1998 crisis, the government seems to have lost interest in pursuing AMDAL, which has generated concern among environmentalists about the seriousness of the post-Suharto governments' commitment to the principle of sustainable development. Environmental sustainability takes a back seat to the pursuit of growth and it is barely institutionally anchored. The massive forest fires of 1997 – 1998, which covered Indonesia and its neighbors in a cloud of smog for months and constituted the area's worst environmental catastrophe of the decade, were started by illegal but

officially tolerated slash-and-burn forest fires set by large landowners in Indonesia. In addition, 2.5 to 3 million hectares of rain forest are cleared in Indonesia every year, approximately 70% of them illegally. According to estimates, currently over 500,000 hectares of rainforest have been logged illegally each year. Only about half of Indonesia's 162 million hectares of rain forest in 1950 still exist today. This illegal clearing is a result of the lucrative palm oil business and the building of too many large paper and cellulose factories, also supported by international development aid, the operation of which can be maintained only with the massive exploitation of ever larger areas of forest. The implementation of new environmental regulations regularly comes up against problems caused by lack of money, environmental consciousness and trained personnel.

Education policy / R&D

State investment in education has increased significantly since the economic reform program began in the 1980s, but most of the support has gone to primary education while higher education is neglected, receiving only only 13% of the education budget. As of the late 1990s, there were approximately 75 state and about 1200 private colleges and universities. In 1999, the government initiated a pilot project in which four state universities became autonomous; other institutions of higher learning are to follow. The primary goal is to increase the efficiency of educational management. Indonesia's educational spending (0.9% of GDP from 2002 to 2004, according to the latest available data) is far below the regional average (for example, Malaysia 7.9%, Thailand 5%), resulting in significant deficits in the areas of research and development. In 2005, Indonesia introduced free education for primary and lower secondary students from poor families in an effort to ensure that all children go through a minimum of nine years of schooling.

Transformation Management

I. Level of Difficulty

Structural constraints

The structural framework conditions for governance performance have improved in recent years, but serious structural constraints continue, such as a high level of corruption. The level of violence has decreased as compared with the previous assessment period, mainly as the result of the Aceh peace agreement and fewer incidents of ethnically and religiously motivated hostility and terrorism, especially as far as insurgencies in Papua and the sectarian conflicts in Sulawesi and Maluku are concerned. Various constitutional amendments, the reduction of the position and role of the military, the fair and free parliamentary and presidential elections of 2004, and the ongoing process of economic recovery since the crisis of 1997 – 1998, have all had a positive impact on the leadership's governance capacity. Rampant corruption, lack of rule of law, inefficient administration, the continued existence of patronage-based networks, high unemployment and underemployment (which is thought to affect 40% of the workforce), and an inadequate infrastructure have put major constraints on the governance capabilities of all administrations during the assessment period. A dispute between the Indonesian police force and the armed forces on the RUU Keamanan Nasional (national security bill) has also constrained governance capacity. The bill was apparently drafted by the armed forces and suggests that the police force must be placed under the Ministry of Internal Affairs (currently it is directly under the president). Predictably, the police force rejected the bill, which has caused tension between the military and the police forces. So far, the president has been unable to settle the problem, and the threat of conflict between the military and the police still lingers. Natural and man-made disasters, such as tsunamis, earthquakes, volcanic eruptions, landslides (as many as 800 over the past decade, almost all the result of deforestation and illegal logging), and forest fires, have all taken a significant human and economic toll on the country and its people while increasing further the level of difficulty for governance. At least 5,800 people died and 36,000 were injured on 27 May 2006 during a 6.3 magnitute earthquake that hit central Java. Since December 2004, Indonesia has lost around 200,000 people in various disasters.

Civil society traditions

Although the roots of civil society in Indonesia lie in a variety of voluntary associations that have existed since colonial times (particularly Muslim voluntary organizations such as the Muhammadiyah, founded in 1912), the fall of President Suharto in 1998 created the environment for the emergence of a politically influential civil society. Several hundred NGOs have been active in the area of political education and election monitoring for the 1999 and 2004 elections. Another field of activity for civic actors has arisen in the socioeconomic area. Numerous NGOs have contributed to cushioning the social consequences of economic chance and the long-term consequences of crises, such as unemployment, poverty and economic inequalities, a task that the state cannot manage on its own.

Conflict intensity

It is important to distinguish between separatism and communal conflicts. Regarding separatist sentiments in areas such as Aceh, West Papua and Riau, the main problem appears to be ongoing conflicts between central and local governments about control over local resources. People in those resource-rich areas are frustrated with the central government's domination over local resources (oil and gas in Aceh and Riau, copper and gold in West Papua). Thus, more than simply being an "identity-based conflict," separatism in those areas is driven by local demands on control over natural resources. This differentiates the separatist insurgencies from other types of conflicts in Kalimantan and Maluku, which are purely identity and faith-based conflicts. The most vicious battleground between Muslims and Christians is Poso, Central Sulawesi. Security in the region is still volatile, especially due to the presence of death squads and radical Muslim clerics from Java who stir up the violence. The police have issued a shoot-to-kill order against perpetrators who refuse to give in, but the violence continues, although in a more limited manner. While the decentralization program implemented since 2001 has been carried out with no major dislocations in public service provision, it does not seem to have improved the structural conditions for efficient and effective governance. Concerns remain regarding the non-equalizing nature of revenue sharing arrangements and the lack of adequate central fiscal instruments to reduce regional disparities. Sustainable conflict resolution currently seems to be achievable only in Aceh.

II. Management Performance

14 | Steering Capability

Prioritization

The successful process of amending the constitution, the decentralization policy initiated in 2001, and an economic policy that has been oriented toward IMF requirements and guidelines even after the completion of the IMF regime in 2003, indicate a policy oriented toward long-term goals. This assessment is further supported by the fact that the government has made various unpopular political decisions, such as the significant rise in gasoline prices in 2005, to achieve the long-term strategic goal of achieving and sustaining economic resilience.

Implementation

The government was able to implement some of the reforms demanded by the IMF, and has maintained a commitment to structural reforms since the IMF regime ended, as demonstrated by successes in the macroeconomic area, such as debt reduction. On the one hand, the government has been successful in improving the central framework conditions for economic consolidation. On the other hand, far-reaching structural changes, such as a thorough banking sector reform and implementing policies to improve the investment climate, have not taken off yet. The will to reform is nevertheless clear. Indonesia's international donors have praised the government for its adoption of a reform driven, sound, medium-term macroeconomic framework. In view of the steady implementation of structural reforms to improve the investment climate, donors believe that Indonesia can achieve its potential growth of 6-7% in the coming years. Despite remaining vulnerabilities, Indonesia's macroeconomic fundamentals are continuing to improve as a result of successfully implemented reforms, with the debt-to-GDP ratio set to decline further, to around 30% by 2010. Unlike in the early years of the democratic era, the government is today less tempted to set aside long-term reform goals in favor of short-term gains. However, while the government is committed to democracy and market economy and the right goals have generally been set, the reform process has been very slow in some areas, particularly as far as the fight against corruption and judicial reform are concerned.

Policy learning

The flexibility and innovation of the political leadership and its ability to learn from past errors is clearly demonstrated by the extensive political and economic reform processes that have been initiated since the crisis of 1997 – 1998.

However, the implementation of some key reforms (for instance, anti-corruption efforts, strengthening of the judiciary, privatization of state-owned enterprises) have been slowed down or hindered by veto actors. The most successful reforms have been carried out with regard to transparency and political decision-making processes, the establishment of mechanisms of checks and balances, and the general strengthening of political and economic institutions, such as the creation of an independent central bank. This is where learning from past mistakes is most obvious.

15 | Resource Efficiency

Efficient use of assets

The government attempts to use resources efficiently, not least because of pressure from the IMF up until 2003, and general domestic and international reform pressure since then, stemming partly from the necessity to attract FDI on a much larger scale than at the time of this report. However, success in this area has been partial. The state's administration is inefficient in many areas as a result of inadequate finances for the bureaucracy, unsatisfactory training and continuing education opportunities for public employees, contradictory laws, and corruption. At the community level in particular, clear boundaries are still not set on transparent planning and execution. The decentralization program, started in 2001, has led more to a reduction of the efficiency level rather than an increase in it, due to often contradictory and hastily passed laws.

Policy coordination

The government's ability to coordinate conflicting objectives and interests is constrained by the prevalence of strong veto actors, such as the armed forces and patronage networks. In 2001, the government embarked on a plan to transfer political power and responsibility for education, health, regional roads, environmental management and other public sector interests from central authorities to regional governmental institutions. Insufficient supervision of the transfer process and the constitution of clear-cut norms and regulations have, however, led to a deterioration of public services and have thwarted development of the private sector. With a view to maximizing short-term benefits, various local governments have started to impose new taxes without considering what negative effects they might have on growth and investment. It has not really been possible to orient local policies on the principle of sustainability in general and the protection of natural resources in particular. It is true in other areas as well that the central government is actually endeavoring to implement announced reforms, but key actors are working against each other, and as the decentralization policy shows, individual policies sometimes have a counter-productive effect on other policies. The government's failure to handle disaster management properly is a further example for the constraints on the delivery of coherent policies. The BRR (Aceh Reconstruction Council) has been

criticized for failure to deliver on its promises and coordinate different foreign and domestic charity organizations in the reconstruction project. The government has also been strongly criticized for its failure to carry out reconstruction following the Yogyakarta earthquake (May 2006), and in dealing with a drilling accident in an inhabited area of Sidoarjo, East Java (August 2006).

Anti-corruption policy

The main political challenges have been the creation of an efficient, independent judiciary and the reduction of corruption. In November 2002, the DPR passed a comprehensive, 72-article anti-corruption law, which, however, has not been effective. Corruption continues to be a major characteristic of the state and administrative culture. However, under the presidency of Yodhoyono, corrupt officials have been prosecuted more consistently than during previous presidencies. Since late 2004, the government has launched investigations into allegations of corruption against dozens of senior bureaucrats, government officials and police officers. In October 2006, the former head of the National Police's Criminal Investigation Division (Bareskrim), Commissioner General (equivalent ranking to a three-star general) Suyitno Landung, became the highest ranking police officer to be jailed when a court sentenced him to 18 months imprisonment for his involvement in the BNI Bank fraud case. Yet, while Yudhoyono's anti-corruption measures have gone further than those of the preceding administrations, his announcement to apply "shock therapy" to the problem of endemic corruption has not born fruit. Corruption also overshadows Indonesia's generally good relations with external actors and hampers FDI. In January 2007, the World Bank announced that it had found 28 alleged corruption cases in its projects in Indonesia and had handed over part of these cases to several institutions for further investigations. Punishment includes the listing of companies that will become ineligible to receive grants or loans from the bank for 15 to 20 years.

16 | Consensus-Building

Consensus on goals

Apart from basic agreement on the general goals of consolidation of democracy and a market economy, key actors have not reached a consensus on what strategies to use to reach these goals. Some issues that have not been clarified include the future relationship between religion and state, the institutional relationship of parliament and the president, the extent of the decentralization process, and the role of state-owned enterprises or the scope of the privatization policy. Political parties, government agencies, intellectuals, and a growing number of NGOs and other civic actors, are competing with each other both in the ranking of goals and concrete reform plans. However, during the assessment period, both government and parliament have successfully dealt with the

challenge posed by radical Islamic groups and defended the secular nature of the Indonesian state. Furthermore, legislative-executive relations are now better institutionalized than they were at the beginning of the assessment period. In particular, the role of the parliament (DPR) has been strengthened vis-à-vis the quasi-hegemonic position of the president as stipulated by the 1945 constitution.

Anti-democratic veto actors

Although the armed forces are under a civilian Ministry of Defense and a gradual reduction of the TNI's sociopolitical role and its role in foreign policy are unmistakable, there is still no "pact" between civilian and military actors that would take away the armed forces' footing in political interventions. At least the TNI's use of blockade power has been limited, not least as a result of the abolishment of reserved seats in parliament for the military. All in all, the judgment of whether the political reformers are able to control the vetoing actors is inconclusive. The veto power of conservative Islamic groups has grown slightly in the 2004-2006 period, and there is hardly any control of the anti-democratic economic actors.

Cleavage / conflict management

During the assessment period, ethnic, religious and regional conflict cleavages have not deepened further, and the government has generally been better-positioned to deal with them than before 2004. The government has yet to find an appropriate long-term strategy to deal effectively with terrorist activities and violence. The economic crisis and the increasing development of civic structures and actors have increased people's willingness to exhibit solidarity, although significant input from the government cannot be seen here.

Civil society participation

In Indonesia, the term civil society (due to the adjective civil) is widely understood as the antithesis to the term "military" (sipil vs. militer). Hence, civil society organizations are perceived as playing a decisive part in balancing the power of state actors in Indonesian democracy. Since the days of the Suharto regime, when the term civil society was used as a conceptual weapon against the caprices of the autocratic regime, the "civil society versus the state" meaning has been taken for granted. As a result, today there is a clear desire to maintain separation between civil society and the state. Among civil society organizations there is also a great deal of controversy about what kinds of assistance are acceptable from government, aid donors and corporations. In general terms, civil society organizations in Indonesia today define their main function as trying to prevent a reversal of the democratization process. However, the borders between the state and the civic sphere have become blurred, and various civil society actors have either been co-opted by state actors or cooperate with the state. This follows the conviction among both politicians and civil society activists that political processes – especially in view of decentralization, conflict resolution, reconciliation and the consolidation of democracy in general – require the participation and involvement of non-state actors to achieve their goals.

Reconciliation

The political elite is willing to recognize (albeit selectively) the necessity of dealing with acts of injustice in Indonesia's past. With certain reservations, this is true of coming to terms with the human rights abuses in East Timor, but no comprehensive reconciliation process has yet taken off. The acquittals of high-ranking military officials accused of human rights abuses have been the norm. This has resulted in a growing perception among civil society actors that the government was not serious about bringing the perpetrators of the New Order regime to justice. The worst atrocities in East Timor were committed in 1999, when Indonesian soldiers and pro-Jakarta militias murdered some 1,500 people in the weeks surrounding an August 1999 vote for independence by the East Timorese. The UN Security Council established a special "Serious Crimes" tribunal of local and international judges and a special prosecutorial unit. Although UN prosecutors won convictions against 85 defendants, most of them were minor militia members. Senior Indonesian generals accused of orchestrating the campaign that led to those murders have remain free and untried. As part of the peace agreement in Aceh, the Indonesian government and the Free Aceh Movement (GAM) agreed to set up a truth and reconciliation commission (KKR), to pursue justice for those who suffered abuse. However, Indonesia's Constitutional Court ruled that such commissions had no legal basis. The law establishing the commission now needs to be rewritten, a process that could take several years. The annulment of the KKR law has allowed President Yudhoyono to avoid, for the time being, dealing with past human rights abuses that are believed to have involved senior officers in the military. There is still a certain reluctance to deal with the mass murders of up to a million suspected communists, many of whom were ethnic Chinese, that were initiated early in the Suharto regime, in the late 1960s.

17 | International Cooperation

Effective use of support

Until the end of 2003, Indonesia's political actors were obliged to collaborate with the IMF, and they took targeted advantage of aid to meet the demands of economic transformation. In addition, there was cooperation with a number of international donors, which has intensified in the wake of the tsunami disaster. All of the more comprehensive projects with international assistance, however, include conditions that are meant to encourage the learning process and changes in the behavior of Indonesia's political actors. Loans from the Asian Development Bank (ADB), for example, are linked to progress in the areas of fighting corruption, legal reform, decentralization, education and health, environmental protection, and infrastructure improvement. The government is attempting to present itself as a predictable partner, but it is coming up against both internal and external obstacles. The governments of both Megawati and now Yudhoyono have to sit on the horns of a dilemma in Indonesia's

relationship with the United States. On the one hand, for reasons of trade policy if nothing else, both administrations wanted to maintain a conflict-free relationship. On the other hand, they needed to maintain the appropriate distance from Washington in the war on terror in general, including the war in Iraq and its aftermath, due to the anti-American sentiment within its populace and the interests of Islamic groups. In 2006 the Consultative Group on Indonesia (CGI) – a consortium of countries and institutions providing loans to Indonesia, set up by the Indonesian government and the World Bank in 1992 – pledged $5.4 billion in fresh loans and grants for Indonesia. In January 2007, President Yudhoyono announced that Indonesia would no longer seek financial aid through the CGI, as there was no longer any need for it. He said that Indonesia no longer needed the special assistance of the CGI because the country was now able to overcome its foreign debt problems on its own.

Credibility

Indonesia has established itself as a credible and reliable international partner. Both attributes were confirmed, for example, when Indonesia repaid its $11.1 billion IMF loan four years early. Indonesia was not scheduled to make its final loan payment until the end of 2010, but it paid the final installment of about $3.7 billion in July 2006.

Regional cooperation

Following a doctrine of “independent and active” foreign policy, Indonesia has been one of the busiest and most influential Southeast Asian states since independence, in terms of international relationships. During this period, political actors have also been active in building up and deepening international cooperation agreements, except for a few brief periods of passivity. Indonesia is still one of the most politically influential countries within ASEAN, the ASEAN Regional Forum (ARF), the ASEAN Plus Three (ATP) Group, the East Asian Summit, and APEC. In sum, Indonesia cooperates politically with its neighboring states, complies with the rules set by regional and international organizations and promotes regional integration. In October 2003, Indonesia hosted the ASEAN summit of the heads of states and governments which concluded with the announcement of an ambitious plan to establish a Southeast Asian Community, partly modeled on European integration, by the year 2020. During 2007 and 2008, Indonesia holds a non-permanent seat on the UN Security Council, providing the country an opportunity to play a greater role in international politics. However, this strategic role does not transform the country into a more prevalent actor in defending, for example, human security and human rights in the region. Indonesia even abstained in the UN Security Council over a possible imposition of sanction against Myanmar.

Strategic Outlook

In the course of the democratization process, political participation has improved greatly along a wide front. About 127 million voters (90% of the voting age population) cast ballots on 5 April 2004 to select nearly 16,000 members of legislatures at the national, provincial and district levels, presumably the largest single-day election exercise in Indonesian history. The legislative elections and two rounds of presidential elections of 2004 were an important litmus test for democratization in Indonesia, which started only five years earlier with the first legislative elections of the post-authoritarian era in 1999. The fair and peaceful conduct of the 2004 elections can be considered a major step toward the consolidation of democratic institutions and processes in Indonesia. Any reversal of this process is currently unlikely, despite the continued de facto political role of the armed forces and the emergence of increasingly vocal and politically influential conservative Islamic groups and politicians who, however, do not normally pursue an anti-democratic agenda.

Stabilizing the party system and creating a formally institutionalized framework for executive-legislative relations are key challenges in consolidating democracy in Indonesia further. Relations between the president and Indonesia's legislative body, the DPR, have so far been shaped by interpersonal networks rather than institutions. For example, after the 2004 elections, the DPR could not fulfill its function due to a disagreement over the selection of commission heads in the parliament between the supporters of President Yudhoyono and the opposition. While the party system is atomized and fluid, the two large nationalist parties, the former state party Golkar and the Indonesian Democratic Party of Struggle (PDI-P), have emerged as the preeminent political forces. However, each must seek coalitions or the ad hoc support of the smaller parties. In this political bargaining game, the strategy of some small radical parties has been to demand pro-Islamic legislation or key posts in the government. This structural setting is unlikely to change in the near future.

During the assessment period, Indonesia recorded the highest growth rate in nine years, despite financial market volatility and high international oil prices. The financial markets and the rupiah have strengthened, and Indonesia has been able to make early repayments to the IMF. This suggests that Indonesia's resilience to withstand external and internal economic shocks has increased since the late 1990s. Growth in excess of 6% (the Indonesian government predicts 6.3% for 2007), which is necessary to achieve a significant reduction of poverty and unemployment, will only be realistic if the government is able to

implement its investment climate improvement program and infrastructure development program.

While vulnerabilities remain, Indonesia's macroeconomic fundamentals are continuing to improve, with the debt-to-GDP ratio set to decline further, to around 30% by 2010, and the overall external position continuing to strengthen, even as the current account gradually moves toward modest deficits over the medium term. In spite of the government's continued sound macroeconomic policy management during the assessment period, growth remains below potential, and unemployment and poverty are still high. Significantly higher levels of domestic and foreign investment are necessary to increase Indonesia's growth performance. The administration's Policy Package for Improvement of the Investment Climate has been welcomed by domestic actors and the international community as an important step toward building a sound foundation for sustained economic development. The package comprises strategies to improve infrastructure, approval of the Investment Law, fairness in tax administration, improvements in customs procedures, and labor market flexibility. According to the IMF, "given the business community's apparent skepticism about quick implementation, early successes in implementing the package would be helpful in enhancing confidence. Similarly, strong leadership will be required to build consensus for reform."