

BTI 2010 | Indonesia Country Report

Status Index	1-10	6.39	# 40 of 128	
Democracy	1-10	7.00	# 37 of 128	↗
Market Economy	1-10	5.79	# 61 of 128	➔
Management Index	1-10	5.87	# 37 of 128	

scale: 1 (lowest) to 10 (highest) score rank trend

This report is part of the Transformation Index (BTI) 2010. 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 128 transformation and developing countries are evaluated.

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Key Indicators

Population	mn.	225.6	HDI	0.73	GDP p.c.	\$	3711
Pop. growth	% p.a.	1.2	HDI rank of 182	111	Gini Index		39.4
Life expectancy	years	71	UN Education Index	0.84	Poverty ²	%	-
Urban population	%	50.3	Gender equality ¹	0.44	Aid per capita	\$	3.5

Sources: UNDP, Human Development Report 2009 | The World Bank, World Development Indicators 2009.

Footnotes: (1) Gender Empowerment Measure (GEM). (2) Percentage of population living on less than \$2 a day.

Executive Summary

In the period under review, Indonesia made substantial progress toward the full restoration of democracy and the rule of law. Available evidence suggests a further stabilization of the political situation is likely after the forthcoming presidential and parliamentary elections. Previously existing ethnic and religious conflicts have declined significantly in recent years, though radical Muslim influence in politics is growing. The human and civil rights situation has also improved to some extent despite some occasional exceptions. Widespread corruption still poses a major threat to transparency and accountability in the political and economic sphere, but recent efforts by the current administration have improved the situation slightly.

Indonesia has also made remarkable progress towards stabilizing the national economy, by reducing both its debt burden and budget deficit. During the review period, Indonesia continued its consistent GDP growth, and its stock market was one of the best performing in the world in 2007. Economic growth, a rise in foreign direct investment (FDI) and ongoing state debt reduction were assisted by an improved investment climate, a consolidating banking system and a more stable exchange rate for the Indonesian rupiah. All these developments led to a modest overall decline in poverty, inequality and social exclusion. However, Indonesia is still a developing country, where half of the population lives below or shortly above the poverty line. Inadequate welfare systems as well as suboptimal education and health care systems, particularly in the eastern parts of the country, constrain human development. However, the financial crisis in 2008 poses a severe threat to the newly achieved improvements. Inflation and decreasing FDI in the second half of 2008 have already been among the first consequences of the overall worsening situation. In addition, the value of the national currency, the rupiah, dropped by 20% to 30% relative to the dollar in late 2008. The government responded promptly with a set of measures to reduce risks for investors and to improve stability in the economic sector.

History and Characteristics of Transformation

From 1966 to May 1998, Indonesia had an authoritarian government under the leadership of General Suharto, which was based on the support of the armed forces, the extensive state bureaucracy and the quasi-state party Golkar. Economically, Suharto transformed the country from a rather poor developing country to a lower-middle-income country. His economic success was made possible by economic conglomerates run by business cronies and family members. Indonesia opened its markets to an influx of Western capital and developed substantial trade relations with the United States, Japan, and other Western countries beginning in the early 1970s. Initially, the government concentrated on labor-intensive industrialization, with firm control over labor movements. Civil society was controlled by means of a system of corporatism, integrating all relevant societal groups into state-sanctioned organizations. Thus, rapid industrialization occurred at the expense of human rights and democracy. The dominant position of state authorities as actors in the development process was characteristic for Indonesia as well as for many East and Southeast Asian countries.

The Asian financial crisis of 1997 – 1998 prompted mass demonstrations, particularly from student organizations that complained about the economic hardships for ordinary people and Suharto's abuses of power. A growing number of Suharto allies left the government, defecting to the opposition camp. As the leadership of the armed forces too abandoned its support, Suharto resigned in May 1998, leaving the presidency to his hand-picked vice president, Bacharuddin Jusuf Habibie. The latter had no other choice but to start negotiations with moderate opposition leaders, ultimately establishing an unwritten pact among political elites. Indonesia thus embarked on a democratization process that included former leading regime members as well as opposition elites. Pivotal political laws were abrogated, the constitution amended, and new parties admitted to the political sphere. In June 1999, the first parliamentary elections were held without major irregularities and a newly composed parliament started to work. In October 1999, the People's Assembly (Majelis Permusyawaratan Rakyat, MPR) elected Abdurrahman Wahid as the nation's new president. In July 2001, Wahid, who had come into growing confrontation with the parliament, was impeached by the MPR and replaced by former Vice President Megawati Sukarnoputri. In 2004, new parliamentary elections and, for the first time in Indonesian history, direct public elections for the country's presidency were held. Incumbent president Megawati was defeated in the second round of the presidential elections in September 2004 by Susilo Bambang Yudhoyono, who received 60.9% of the votes. Indonesia's sixth president is a retired general from the armed forces (Tentara Nasional Indonesia, TNI), who previously had served under Suharto as the armed forces' chief of staff for social political affairs, and as coordinating minister of politics and security in the Megawati cabinet. Despite his strong popular mandate, his Democrat Party is only the fourth largest party in the House of Representatives (DPR), having won only 56 of 550 seats in the parliament. Therefore, Yudhoyono is strongly dependent from the largest political party in the DPR, Golkar, whose chairman Yusuf Kalla serves as current vice president.

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 overthrow the current system of government. However, some serious challenges on the road to further democratization persist. These include failings in the rule of law, an inefficient administration, the continued existence of patronage-based networks leading to widespread corruption and the growing political influence of conservative Islamic groups. The Yudhoyono administration also faces challenges in creating well-paid jobs for the growing population, and in improving living conditions for large parts of society.

Under the strict supervision of the IMF, the post-Suharto administrations have made an effort (starting in 1998) to drastically reform the economic sector. President Megawati is credited with stabilizing Indonesia’s volatile post-1997 economy. However, she 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 Yudhoyono administration has identified infrastructure construction and the fight against graft and corruption as priority areas, although it has made only slight progress in these areas. In 2005, the Indonesian economy finally returned to the GDP level reached before the 1997 crisis. In the following years, Indonesia witnessed solid economic growth rates between 4% and 6%, along with some progress in the liberalization of its economy.

Transformation Status

I. Democracy

1 | Stateness

In the first years following the regime change, the nationwide implementation of the state's monopoly on the use of force was one of the greatest challenges of the Indonesian state. Communal violence occurred in nearly all parts of the archipelago, sometimes with ethno-religious or separatist undertones. These conflicts have diminished significantly in recent years, and the power of local guerrillas and paramilitary units has been curbed. However, in the easternmost province of Papua, and in other remote and outer islands, the official administration is often eclipsed by local strongmen and military units stationed in the area.

Monopoly on the use of force

Indonesia is an extremely multi-ethnic, multilingual and multi-religious state. The creation of a state within the borders of the former Dutch colony was an attempt to unite a large number of ethnic groups into one common nation. The fast and nationwide spread of the new national language "Bahasa Indonesia," and the success in the war of independence against the Netherlands, created a spirit of unity and Indonesian nationalism among the many different ethnic groups in the archipelago. Nowadays, all citizens formally have the same civic rights and an anti-discrimination law aims at preventing unequal treatment of Indonesian citizens. However, some nationalist or separatist groups such as the Free Aceh Movement (Gerakan Aceh Merdeka, GAM) utilize local grievances in hopes of constructing a competing national identity among their "target" populations.

State identity

Since independence in 1945, Indonesia adheres to the official state philosophy of Pancasila, which is written down in the preamble of the constitution. Therein, the belief in one god is enshrined. Despite the fact that about 87% of Indonesian citizens are Muslims, Indonesia is not a secular but also not an Islamic state. Nevertheless, since the start of the democratization process, the political influence of the radical orthodox Muslim community has grown, with increasing pressure for the government to act on religious issues. The controversial anti-pornography law and the regional Shari'ah-based by-laws are examples of the ongoing debate about the role of religion in state's affairs.

No interference of religious dogmas

The process of decentralization initiated in 1999 represents the most decisive transformation of the administrative infrastructure in Indonesia's history. Local governments now have authority and control over about 50% of the total government budget. According to some observers, decentralization has intensified problems of administrative efficiency and political steering. But in general, the state's fundamental infrastructure extends throughout the entire territory of the country. However, due to the country's large size, this administrative operation is deficient to some extent.

Basic
administration

2 | Political Participation

Every five years, the Indonesian people directly elect the president, the House of Representatives, the Regional Representative Council and the local Houses of Representatives. Additionally, the district chiefs and mayors are elected directly. Since 2004, the president and the vice president are elected directly by the people with an absolute majority.

Free and fair
elections

General elections are held and accepted in principle as the means of filling leadership positions. Some problems with cheating and money-based politics exist prior to elections, but both the legislative and presidential elections of 2004 were conducted largely in line with democratic standards.

In principle, elected leaders have the power to govern without any restraint. However, there are some informal veto players with the power to restrain executive actions. Most importantly, the armed forces have the right to interfere with the elected government if they believe the unity and stability of the Indonesian nation to be threatened. There are also some minor radical Islamic groups, which seek to abolish democratic rule and to replace it with a theocratic state or caliphate.

Effective power to
govern

Indonesia has a vital NGO scene, particularly in the larger cities and in Java. As part of the decentralization process, local interest groups can contribute to political decision-making at the communal level. At the national level, non-profit interest groups and independent trade unions have more difficulty in making their demands heard. The rights of assembly and association are widely accepted, and used by many Indonesians. Frequent demonstrations in front of local and national department buildings and parliaments are a common feature of Indonesia's daily life.

Association /
assembly rights

In the years after the regime change, freedom of expression was established as a pillar of democracy. Indonesia's press is one of the freest in Southeast Asia. In the World Wide Press Freedom Index, published annually by Reporters Without Borders, Indonesia ranks at 100th place, while countries such as the Philippines, Thailand and Singapore range far below it. A broad variety of television and radio

Freedom of
expression

stations exists, which can report freely and whose programs are only influenced by their owners. However, there have been in practice some examples of action which has violated the constitutionally protected freedom of expression, and several cases have been tried by courts.

3 | Rule of Law

As a result of the constitutional amendments passed between 1999 and 2002, the constitution now provides for the basic constituents of democracy, establishing a presidential system of government with a clear separation of powers between the executive, legislative and judicial branches. Indonesia now has a system of mutual checks and balances between the three state authorities, which in daily practice functions relatively well.

Separation of powers

The judiciary was established as a distinct profession after regime change in 1998, and operates now relatively independently. However, regime change did not result in a big exchange of personnel in this branch of government. This helps explain why the judiciary has regularly been influenced by the military, business interests and politicians outside of the legal system. Bribes have frequently influenced prosecution, conviction, and sentencing, in countless civil and criminal cases. Consequently, courts often make decisions in favor of the rich and powerful. By contrast, the recently founded constitutional court appears to be a valuable contribution to the democratization process, issuing reform-oriented decisions. In addition, a judicial commission has been established tasked with monitoring and fighting corruption in the judicial sector.

Independent judiciary

Former President Suharto, who in his dictatorial rule allegedly amassed billions of dollars of private wealth and was responsible for massive human rights violations, was never brought to justice for his immense abuses of power. He died as a free man in January 2008.

Prosecution of office abuse

In terms of tackling corruption, Indonesia has made some slight improvements in recent years but is still among the most corrupt nations in the region.

The civil rights environment has significantly improved since the end of authoritarian rule and the cessation of the various local conflicts in the subsequent years. However, civil rights are still violated in some parts of the country. This often takes the form of police and military actions against civilians, particularly in the Papua. The civil rights of women are increasingly curtailed by the implementation of Islamic regulations in about 10% of its districts. Anti-terror laws issued after the 2002 terrorist attacks in Bali have also been criticized for curtailing civil rights.

Civil rights

4 | Stability of Democratic Institutions

The performance of democratic institutions has slightly improved in recent years. This is particularly true of local governments, which following decentralization were better able to deal with their increasing responsibilities. At the national level, President Yudhoyono has not yet been able to streamline the administration. His cautious and often rather indecisive leadership style has left many administrative problems untouched.

Performance of democratic institutions

In general, all relevant political and social players accept democratic institutions as legitimate. Court decisions, even if controversial, are accepted by all public actors. Due to procedural deficiencies in the administration of elections, the losing parties or persons quite often publicly question the rightfulness of election results. However, they have to date all accepted court decisions on these matters. Nevertheless, there are radical groups which do not accept democracy. It also remains to be seen how strong the commitment to democracy is among Islamist parties or the military in the case of a national political or economic crisis.

Commitment to democratic institutions

5 | Political and Social Integration

Unlike other political systems in Southeast Asia, political parties play a very important role in Indonesian politics. The political parties represent distinct ideological streams and are not simply vehicles of personal interest. Additionally, the proportional election system for the national and local parliaments give the parties the right to choose the individuals they want to represent them, by means of party lists. Compared to other new democracies, the Indonesian party system is very stable, and can be characterized as a fragmented party system comprising two large, five medium-sized and dozens of smaller parties. In the parliamentary election of April 2009, 2.5% of the national votes will be required to win any seat in parliament. Therefore, fragmentation will be greatly reduced. The election law requires parties to open offices in every province of the country in order to reduce the influence of regional or ethnic interests on the national level.

Party system

Indonesia has various interest groups representing many aspects of social life. Islamic associations such as Nahdlatul Ulama and Muhammadiyah are the most significant and best-organized intermediary actors. They also have certain political influence, since their comments on political and social developments are followed by a great number of people. Trade unions play a less significant role in Indonesian national politics. Although Indonesia's level of unionization has risen from 1.4% in the mid-1990s to about 10% of the total labor force in 2007, the unionization rate is still among the lowest in Southeast Asia.

Interest groups

Various surveys such as the Asian Barometer Survey and national opinion polls show a relatively high support for democratic values. However, the initial euphoria of the first years of democracy is a thing of the past. As the new political system has shown weaknesses, many people have become disappointed. Democracy's start came at an extreme economic low point in 1998, yet most Indonesians have not seen economic progress and growing incomes become reality. Consequently the number of people who see the years of Suharto's authoritarian rule in a nostalgic and romanticized way has risen.

Consent to
democratic norms

In the years after the regime change, associational activities increased substantially. More and more people turn to organization as a means of confronting and surmounting socioeconomic barriers. Although the influence of civic actors or self-reliance organizations on the national level is still limited, many organizations are active at the local level. Many cooperate with foreign donor organizations. Indonesia has a widespread and heterogeneous network of autonomous, self-organized groups, associations and organizations.

Associational
activities

II. Market Economy

6 | Level of Socioeconomic Development

The solid growth over the past five years, as well as aid programs by the government and international organizations, have led to a modest overall decline in poverty, inequality and social exclusion. Still, Indonesia is affected by disparities across regions and between genders. Although the country's HDI score rose from 0.711 in 2004 to 0.728 in 2005 (the latest data available), with a ranking of 107th out of 177 countries, the GDI value has consistently remained at a lower level, indicating persistent gender inequality.

Socioeconomic
barriers

Regional inequality is also due to differing allocations of natural resources and varying population densities, which determine employment opportunities. The recent acceleration in growth has helped lead to a decrease in the proportion of the population below the poverty line, from 16.6% in early 2007 to 15.4 % in early 2008.

Economic indicators		2004	2005	2006	2007
GDP	\$ mn.	256836.9	285868.6	364570.5	431933.3
Growth of GDP	%	5.0	5.7	5.5	6.3
Inflation (CPI)	%	6.2	10.5	13.1	6.4
Unemployment	%	9.8	11.2	10.3	9.1
Foreign direct investment	% of GDP	0.7	2.9	1.3	1.6
Export growth	%	13.5	16.6	9.4	8.5
Import growth	%	26.7	17.8	8.6	9.0
Current account balance	\$ mn.	1563.0	277.6	10859.1	10492.2
Public debt	\$ mn.	71822.4	71728.8	67117.4	68707.9
External debt	\$ mn.	139555.0	132794.2	130800.2	140782.6
Total debt service	% of GNI	8.3	6.1	6.6	3.5
Cash surplus or deficit	% of GDP	-1.1	-	-	-
Tax Revenue	% of GDP	12.3	-	-	-
Government consumption	% of GDP	8.3	8.1	8.6	8.3
Public expnd. on edu.	% of GDP	2.7	2.9	3.6	3.5
Public expnd. on health	% of GDP	0.8	1.0	1.3	-
R&D expenditure	% of GDP	-	-	-	-
Military expenditure	% of GDP	1.4	1.2	1.2	1.2

Sources: The World Bank, World Development Indicators 2009 | UNESCO Institute for Statistics | International Labour Organization, Key Indicators of the Labour Market Database | Stockholm International Peace Research Institute (SIPRI), Yearbook: Armaments, Disarmament and International Security.

7 | Organization of the Market and Competition

Indonesia's government has not yet established a complete institutional framework for a functioning market economy. Despite the progressive implementation of free-market reforms since the 1980s, market competition remains weak, and is impaired by state interference. As a legacy of the crony capitalism under the Suharto regime, state-owned enterprises (SOEs) retain a large stake in Indonesia's economy. Though there have been privatizations, such as in the electricity and water-supply sectors, 135 SOEs still existed by the end of this review period. This limits

Market-based
competition

competition, as the state uses the SOEs to interfere in price formation by means of subsidies and, in the case of monopolies, price dicta.

The growing, if partial, regional autonomy, which is meant to provide a stronger sense of regional competition, has in fact led to overregulation and an opaque investment environment. Furthermore, a distinct patronage network, rampant corruption and the preferential treatment of SOEs by officials has undermined private sector development. As a result, Indonesia was ranked 129th out of 181 countries in the World Bank's Doing Business 2009 report. Property rights enforcement is weak, and foreign investment is still heavily restricted.

The lack of political will prevents the complete divestiture of monopolies and a comprehensive privatization of state-owned enterprises (SOEs). The fragmentary implementation of the 1999 Cartel Act, the patronage network linking politicians, the military and the large enterprises, and even Article 33 of the constitution, which defines the preeminent role of SOEs in key economic sectors and protects them from private competition all require further adjustment. The lack of efficiency and competition, along with the accompanying corruption attributable to the SOE system constitute the main obstacles for the Indonesian economy.

Anti-monopoly
policy

Indonesia is becoming progressively more integrated into international trade flows. As a condition of the IMF's structural adjustment program after the 1997 crisis, the government took measures to reduce tariff barriers and joined regional trade associations. However, foreign trade is still restrained by an opaque system of licensing, and the ineffective administrative implementation of trade policies. According to OECD's first assessment report in 2008, Indonesia's ratio of FDI to gross domestic income (GDI) is among the lowest in Southeast Asia, due to restrictive direct investment rules. Additionally, the lack of contract enforceability causes uncertainty and hampers contract conclusions. Meeting the requirements of membership in the WTO, the ASEAN Free Trade Agreement (AFTA) and the Asia-Pacific Economic Cooperation (APEC) will require the country to reduce tariffs continually until 2020. However, maintaining the competitiveness of Indonesia's import-dependent manufacturing sector will provide even stronger incentive to reduce both tariff and non-tariff trade barriers.

Liberalization of
foreign trade

Among the results of the 1997 crisis were consolidation in the banking system and adjustments in the institutional banking framework. Although regulators plan to implement Basel II requirements in 2009, capital requirements for banks are already high. Regulations limiting investments abroad and establishing strong supervision by the central bank are in place. In 2008, the Indonesian banking system was made up of 128 banks, with only 11 characterized by majority foreign ownership. The four state-owned banks control about 38% of the sector's assets. The low exposure

Banking system

to speculative capital flows and the early measures by the central bank and the government aimed at ameliorating liquidity shortages are positive signs for the continued stability of Indonesia's banking sector during the financial crisis.

8 | Currency and Price Stability

As Indonesia is consistently plagued by high inflation rates, the central bank has put strong emphasis on a restrictive money supply, targeting an inflation rate of 3.5% in 2013. In contrast, by cutting oil subsidies to about 29% in May 2008, the government fuelled inflation to a peak of 11.9% in July 2008, following an already-high level of price increases due to the increased food prices. Consequently, the central bank was forced to take countermeasures by increasing interest rates, to 9.5% by October. Since that time, Bank Indonesia (BI) has repeatedly cut rates in hopes of stabilizing the economy. The currency, the Indonesian rupiah (IDR), is maintained under a managed-float exchange rate regime, although BI has issued regulations limiting speculative capital flows that may increase currency volatility. Over the past six years the exchange rate against the dollar was held relatively stable by means of accumulation of foreign exchange reserves, with the goal of stimulating export-driven growth. In late 2008 the Indonesian rupiah lost a fifth of its value against the dollar, but the slide has since halted.

Anti-inflation /
forex policy

Remarkable efforts have been made to reduce total public debt. Supported by increasing tax revenues and a continuing trade balance surplus, the ratio of total government debt to GDP has fallen from 100% in 1999 to 40.8% in 2006, and is expected to reach 35% to 30% in 2009. This has given the government room to run a more expansive fiscal policy in order to counteract the effects of the global economic downturn. The rating agency Fitch upgraded Indonesia's long-term foreign currency rating from B+ to BB in 2007. Due to higher tax revenue and improved cost efficiency, Indonesia has lowered its budget deficit from 1.5% in 2007 to 1.1% in 2008.

Macrostability

9 | Private Property

The implementation of property rights is constrained by a deficient legal framework, ineffective administration and widespread patronage networks. On the International Property Rights Index of 2007, Indonesia ranked only 47th out of 70 countries. Concerning the legal and political environment, Indonesia scores especially low with 2.5 points, but shows strength in the area of physical property rights with 6.0 points out of seven. Therefore, there has been slight but continuous progress in improving economic freedom.

Property rights

Although the Indonesian economy is dominated by private enterprise, particularly in the informal sector, SOEs still play a significant role in several business sectors. In 2007, SOEs contributed 40% of the nation's GDP.

Private enterprise

Although private businesses are partially allowed to enter SOE-dominated sectors, current efforts at liberalization remain insufficient. Although the government started an initiative in 1995 aimed at allowing private companies to enter the petroleum and gas industry, exploration contracts were issued to various domestic and foreign oil companies only in 2005.

10 | Welfare Regime

Although there have been several attempts since the 1970s to establish social safety institutions, today's social security system stems mainly from a series of reforms in 1992, introducing a social insurance system (Jamsostek) which partially covers medical care. However, since it is only for employees of the formal sector, it cannot cover the roughly two-thirds of the working population that work in the informal sector. Confronted with differing population densities across the various regions, the health care infrastructure is deficient and overstrained.

Social safety nets

Although various efforts have been made to ease and compensate for regional and other disparities, equal opportunity is as yet an unrealized goal. Regional differences as well as urban-rural biases determine access to services, health care, work and education. The main disparities in these sectors can still be found between Java and the other islands. Investments in infrastructure and the internal migration program require further adjustments. Disparities between ethnic minorities are also evident.

Equal opportunity

11 | Economic Performance

Though below the regional average, Indonesia's growth has been consistent, peaking at 6.3% in 2007, the highest rate since the 1997 crisis. In 2008, forecasts targeted a growth rate of about 6%. The country's stock market was one of world's best performing in 2007, reflecting profits from high prices for exported commodities, a strengthened domestic market and a high level of investment. This economic growth, growing levels of FDI and ongoing reduction in state debt was made possible by an improved investment climate, a consolidating banking system and a stable exchange rate for the Indonesian rupiah. Driven by domestic demand, Indonesia was the only country in Southeast Asia to avoid economic downturn in the first half of 2008, instead experiencing massive growth in exports (28.2%) and imports (47.0%) until July 2008. However, as a net exporter, Indonesia's economic development has been highly affected by the erosion of commodity prices and

Output strength

volatile capital flows, with investors still cautious after the collapse in 1997. In the second half of 2008 the stock market fell by 58%, and FDI and domestic investment decreased substantially. Exports are also expected to dampen in 2009, since Japan – the biggest export destination for Indonesia’s manufactured products – is expected to reduce its demand due to the financial crisis. However, since domestic demand accounts for two-thirds of GDP, the consequences of decreasing export demand will not be as harsh as for other countries in the region.

12 | Sustainability

Indonesia became known for massive deforestation in the late 1990s, when the country’s heavy smog began affecting neighboring countries. To date, institutionalized protection of the environment has remained inconsistent and superficial. For example, in February 2009 Indonesia abolished the moratorium on the clearing of peatland, although this type of environment is well known for its absorption of CO₂. Indeed, there is hardly any institutionalized protection of the environment. Since the decentralization process shifted authority over the exploitation of natural resources to local governments, short-term economic gains have clearly outweighed awareness of the importance of sustainability. About 500,000 hectares of rainforest have been logged illegally every year, not least for palm oil plantations. Indonesia has hugely increased the acreage devoted to biodiesel, and has now displaced Malaysia as the world’s biggest palm oil producer. The reverse side of the development is that Indonesia has already become the number three producer of CO₂ emissions worldwide, after the United States and China.

Environmental
policy

Since the 1970s, Indonesia has steadily improved its education enrollment rates. In 2005, 90.9% of eligible children were enrolled at the primary level, but only 60.2% enrolled at the junior secondary level. According to the Asian Development Bank, the main remaining challenge is to smooth this transition from the primary to the secondary level.

Education policy /
R&D

R&D spending is relatively low. Analysts say that a lack of incentives for R&D has contributed to the low quality of industrial products. In 2007, spending on R&D by the government was about 0.4% of total GDP, considerably lower than that of most neighboring countries.

Transformation Management

I. Level of Difficulty

Since the beginning of the economic reform process in 1998 and the beginning of political reform in 1999, the structural conditions for governance have significantly improved. Their continued improvement remains a priority of the government. Economic liberalization, new laws giving more certainty to investors and ongoing investment in the development of infrastructure have consolidated the economic situation. Ethnically and religiously motivated hostilities have strongly declined since the signing of the peace agreement in Aceh and the implementation of its status as a special autonomous province. The capacities, and thus the political influence of veto actors have been curtailed due to constitutional reform. After 2001, the military was forced to withdraw from politics, and accepted major cutbacks in its authority. Another constraint on veto actors was the establishment of the Corruption Eradication Commission in 2004, which has had real impact in addressing corrupt decision-making and business practices. However, the lack of the rule of law, an inefficient administration, underdeveloped infrastructure, the ongoing existence of patronage-based networks and corruption all remain heavy constraints on governance capabilities.

Structural
constraints

Natural disasters and the ongoing destruction of forests pose a severe threat to the country's stability of the country. Disasters such as the 2004 tsunami in Aceh, the earthquake in Yogyakarta in 2006 and landslides (which mainly result from illegal logging and forest fires) have caused significant loss of life, with estimates as high as 200,000 victims since 2004. The disasters have also exposed the government's inability to provide short-term help or to coordinate recovery missions and reconstruction programs. The government has thus lost much legitimacy with the population.

The global financial crisis, which showed its first consequences in Asian markets in 2008, is expected to pose the greatest challenge yet to the current administration, and will show its real effects in 2009. At the end of this assessment period, the economy was showing early signs of regression, leading to a decline in expectations

for 2009 concerning growth and assets. Consequences will be especially hard for human development, since the unemployment rate is expected to rise and prices have already risen significantly.

Indonesia has moderately strong civil society traditions. The NGO scene is particularly vital in larger cities and in Java. As part of the decentralization process, local interest groups can contribute to political decision-making at the communal level. Civil society organizations increasingly engender social capital, one of the key assets that can protect the poor and vulnerable from economic hardship. NGOs consequently address contested issues such as human right abuses or lack of protection by the state, and are often threatened by radical nationalist or Muslim groups. By far the biggest and most important organizations in the field of social welfare and education are Muslim mass organizations such as Nahdlatul Ulama and Muhammadiyah. However, both of them have taken a clear stance against fundamentalist Islamic tendencies, and prominent figures from these two organizations are increasingly involved in national and international networks of interreligious dialogue.

Civil society traditions

In former conflict areas such as Aceh, Central Sulawesi, South Kalimantan or the Moluccas, the state has been able to regain administrative power and contain violence. The relatively successful implementation of the decentralization process, resulting in effective local autonomy, is one of the most important reasons for this development.

Conflict intensity

In the province of Aceh, one of the longest and bloodiest conflicts in Indonesia's recent past was relatively recently brought to an end. A memorandum of understanding between the Indonesian government and the Free Aceh Movement (Gerakan Aceh Merdeka, GAM) in Helsinki in 2005, paved the way for the new Law on the Governing of Aceh, which grants the province limited autonomy in political, economic, cultural and judicial matters. Aceh, which is now under the rule of a directly elected former GAM activist as governor, has seen a stabilization of its political situation.

While peace and a shared monopoly of power between central and provincial government in the westernmost part of Indonesia has thus been firmly established, the easternmost province of Papua is still riddled by various conflicts. Here, and in other remote and outer islands, the official administration is often eclipsed by local strongmen and or military units stationed in the specific area. However, violence still occurs all over the country, often in demonstrations and public hearings, especially because of religious issues. The offices of newspapers, NGOs, and non-Muslim buildings sometimes get ransacked by "rented mobs," since radical religious and nationalist groups are able to mobilize great numbers of people.

II. Management Performance

14 | Steering Capability

The current Yudhoyono administration has shown its commitment to reform and development, pushing ongoing reform agendas and seeking to adjust the economy to international standards. The decentralization process, giving greater authority and responsibility to local governments, has been one of the top priorities of Indonesian national politics, and has been progressively implemented and structured by new regulations.

Prioritization

The theme of 2008's National Medium-Term Development Plan was "accelerated economic growth for job creation and poverty reduction." The plan targeted an increase in investment, the revitalization of rural development, improvements in infrastructure and energy management, improvements in the accessibility and quality of education and health services, the eradication of corruption, bureaucratic reform, and improvements in domestic security and disaster response. The passage of several laws (such as a new investment law) which have been the subject of debate for several years indicates an ongoing commitment to adjusting the economic sector to the requirements of the international market, and to international investors' interests. However, this reform process has been slow, and has not been as sweeping as hoped by foreign advisers. Foreign economic activities are still constrained by a negative investment list published in June 2008, which outlined sectors where foreign investment is still restricted. On the other hand, the improvement of people's welfare was identified as the government's highest priority, "essential for the nation's future" within the development plan, and activities aimed at this goal were given an expanded budget allocation. In 2009 the government also plans to increase subsidies for universities, improving the capacity and quality of tertiary education.

Implementation of political and economic reform initiatives is still a major problem, often proving more difficult even than the protracted parliamentary process leading to their passage. The implementation of basic administration policy is sometimes inconsistent, as was evident in the case of 2008 fiscal policy. Bureaucratic inflexibility and missing initiatives resulted in a very low realization of public investment potential. More than 40% of the budget was left unspent in 2008. Economic growth has also been hampered by the withholding of funds for credit programs.

Implementation

The Yudhoyono administration showed remarkable flexibility and innovation with respect to the reduction of various subsidies and the reform of the currency and stock markets. Because of a range of government-provided subsidies for food, fuel, fertilizer, and electricity, rising international food and oil prices in the first half of 2008 produced considerable pressure on the government's budget. Based on oil prices of \$127 a barrel, the costs of the subsidies would have absorbed about 30% of the government's budget in 2008. Therefore, fuel subsidies were cut by nearly 29% in May 2008, a sign of the government's realistic assessment of its budget and its willingness to sacrifice short-term political gains to long-term economic requirements. To reduce negative consequences for the poor the government also introduced a direct cash compensation package, as well as several subsidy programs aimed at stabilizing food prices.

Policy learning

To prevent a repeat of the disastrous consequences of the Asian crisis, the Yudhoyono administration acted decisively in late October 2008, introducing a set of measures designed to stabilize the currency and stock markets. The Ministry of Finance began repurchasing treasury notes in order to boost liquidity in the bond market, and bilateral currency-swap agreements with the central banks of Japan, Korea and China were signed, to be implemented if necessary. Regulations were introduced to monitor foreign exchange transactions more effectively, while upholding the country's free foreign exchange regime.

15 | Resource Efficiency

The government fails to use available assets in the most efficient manner, either to boost economic growth or to manage its own budget. After a recent report estimated that the country's income taxpayer base was as low as 0.1% of the eligible population, the government introduced a fine for unregistered taxpayers. Hence, tax revenues rose by about 50% in the first ten months of 2008. This is a promising development, but the allocation of the budget is still poorly managed, with 40% of funds disbursed in the last month of the year. While priority is officially given to human development and the improvement of living conditions among the poor, education and health services are the first sectors to lose funds due to national budget shortcomings. Revenues from natural resources still make up the biggest share of the national budget, but the government has not improved domestic excavation and refinement techniques, therefore wasting potential assets. While Indonesia is a net exporter of crude oil, it imports fuel from other countries due to the lack of domestic refineries. A special clause in the 2009 budget law can be evaluated as another positive development concerning the requirement and

Efficient use of assets

allocation of assets. Spending can now be shifted between programs and government agencies more easily in order to provide effective resource allocation. The special clause has facilitated a process of budget shifting, drawing emphasis away from political deliberations in the House of Representatives.

In the current system of government, the presidency is dependent on the support of the legislature to pursue its policies. The Yudhoyono administration has enjoyed a stable and broad majority in the legislature. However, negotiations with the DPR on specific policies are often time-consuming, and have delayed political decision-making in several policy areas. Additionally, there is friction between various ministries, which do not pursue coherent goals. For example, the decentralization policy has suffered from a lack of coordination between the Ministry of Finance, the Ministry of Home Affairs and the National Planning Board (Bappenas). Efficient policy coordination between the several layers of national administration, particularly between the national, provincial, and district levels, also poses a serious challenge in Indonesia.

Policy
coordination

Nevertheless, policy coordination has improved, even as legislation remains inefficient. The Anti-Corruption Commission has been opposed by veto actors, some pushing to abolish it even after implementation. Veto actors still exert influence on policy formulation within parliament, hampering the effective use of assets, the fight against corruption, and effective bureaucratic reform, among other goals.

In September 2008, tax reform legislation was passed cutting corporate income tax from 30% to 28% in 2009 and to 25% in 2010, including additional reductions for micro, small and medium-sized businesses. Personal taxes and taxes on dividends have also been reduced considerably. Hence, tax policy was well-tailored to give investment incentives that might counteract the negative effects of the financial crisis. In addition, measures aimed at strengthening the banking industry and stock market, and to revive investors' confidence, can be described as quite strategic since 80% of the country's financial assets are concentrated in banks.

Although corruption remains endemic in the Indonesian political and economical system, the Yudhoyono administration has put up a serious fight against it. Yudhoyono used the struggle against corruption as a major element in his 2004 election campaign and enacted a special Corruption Eradication Commission (KPK) aimed at restoring investors' confidence in the rule of law in Indonesia. The KPK consists of 30 policemen, 25 independent prosecutors, 50 investigators and a special Corruption Crimes Court. It is endowed with wide-ranging powers to make arrests and summon political officeholders to testify. The KPK investigates, prosecutes and sentence faster and more effectively than the traditional police forces. Its success can be seen in the arrest of several high-ranking political figures, including former senior Foreign Ministry official Slamet Hidayat, several

Anti-corruption
policy

members of the national parliament, the former director of the Central Bank Burhanuddin Abdullah and two other top officials Oey Hoey Tiong and Rusli Simanjuntak, as well as the exposure of over 400 billion rupiah in pilfered money in 2008. However, the KPK's work has also been criticized for lacking a structural approach to the problem. Although the arrests of high-ranking political figures might have a deterrent effect on other people's behavior, they only scratch the surface of a culture of corruption that pervades all levels of social and political life.

16 | Consensus-Building

In general, the goal of improving the living standard of all Indonesian citizens enjoys consensus. Corruption has been generally defined as a major societal problem, affecting the economy, politics and foreign investment, but the means to fight it have not been agreed upon. Except for a small minority of Islamist groups that envision a caliphate in Indonesia, democracy has become the consensually accepted form of government. Basic protections for human rights enjoy general support, despite the still-negative impact of some veto players.

Consensus on goals

The political leadership has to date lacked a coherent set of strategies for the consolidation of democracy, which can be seen in the ongoing influence of the military in the political arena. The market economy still shows signs of protectionism, as well as constraints on privatization that hamper investment. Although the government has shown some willingness to limit the influence of Islamist groups on public life, and has so far sustained the secular nature of the state, several developments described above show that the future state role of Islam remains a contested issue. Foreign policy orientation towards the United States and the West also remains an unsettled topic. Although foreign investment and the support of development organizations are still needed, fears that growing Western influence will undermine the nation's independence and integrity persist.

The Yudhoyono administration has had to deal with two potential anti-democratic veto actors, the military and radical Islamic forces. The role of the military in politics has been contained in recent years, however. For example, the practice of reserving 38 parliamentary seats for the military was abolished in 2004. Peace in Aceh has further diminished the military's political role. Nevertheless, generals and other high military personnel have been successful in elections on the provincial level, turning the decentralization process into another test of military influence on the political system. Military personnel also remain serious potential veto actors in the economic reform process. Some SOEs and other important business structures are still controlled by high-ranking military officers.

Anti-democratic
veto actors

Market liberalization, the fight against corruption, foreign investment and bureaucratic reform pose severe threats to the oligarchic structures of longstanding

economic elites. Therefore, reform on these issues has been delayed for years. However, the new laws on investment and income tax show a partial success for reform-oriented government actors.

Islamic forces pose a challenge to the reform process as well. Government agencies are forced to deal with an ongoing Islamization of public life, such as the use of Shari'ah by-laws in various districts, and the violent demeanors of religious groups. The government has made several concessions to Islamist groups, as with the passage of the anti-pornography law and the insufficient protection offered to the Ahmadiyah group. Therefore, government has shown itself ready to consider demands by radical Islamic groups, in order to avoid confrontation with the large mainstream Muslim population that will vote in the 2009 elections.

During the period under review, the government was able to lessen the impact of a number of cleavages and conflicts. Decentralization has helped abate the cleavage between center and periphery, or specifically Java and the other islands. However, Java has retained its role as center of gravity for the nation's economy, politics and public life. With the beginning of the peace process in Aceh, the government showed its ability to settle long-term conflicts in a non-violent manner. However, the consolidation of peace and the political status of the province have yet to be permanently settled from the point of view of the central and provincial governments, as well as other key actors. Religious cleavages have deepened due to an ongoing Islamization of public life, which can be seen in an all-too-careful handling of radical Islamists. Although religiously motivated terrorism has declined, the government still lacks a long-term strategy to deal with terrorism. Violence is still an endemic problem in society, from the family level to the government's dealing with provincial separatist movements and conflicts in regions such as the Moluccas and Papua. Since the government's efforts to reduce poverty have been largely short-term, lacking a structural approach to the problem, the cleavage between labor and capital has not yet been reduced. On the contrary, unemployment, underemployment and a rising number of poor, exacerbated by the consequences of the financial crisis, will sharpen the problem in 2009.

Cleavage /
conflict
management

At the national level, non-profit interest groups have considerable difficulty in making their demands heard, as the administration still holds some resentment against them. Often, the bureaucrats regard these groups as being sponsored by foreign donor organizations, thus not representing the interests of ordinary Indonesians. Therefore, a new regulation, introduced in December 2008, requires NGOs to seek state approval of foreign funding. Originally, the regulation was aimed at clarifying a 1985 law allowing suspension of organizations which receive foreign funds without government permission.

Civil society
participation

However, critics emphasize the draconian character of the regulation. Fears have also been raised that the freedom of mass organizations might be threatened by new

laws which – at the time of this writing – were being drafted by the Ministry of the Interior and the Ministry of Justice.

Independent trade unions are of some importance in several sectors of Indonesia's industries, but are at times harassed by thugs in the pay of company owners, who try to prevent strikes and production disturbances. Several cases have been reported of trade unions and other workers' organizations that have been threatened under anti-terror laws in order to prevent them from issuing reports on environmental concerns or abusive employment conditions.

Neither the political elite nor the general population seems to have accepted the need for any effort to deal with the past, or to establish a reconciliation process. Only a few NGOs, with the support of governmental agencies, continue to address the issue despite severe harassment and threats by the military and nationalist groups. The victims of the Suharto era are manifold, and only a small proportion have been granted restitution today. However, the worst atrocities took place not only during the Suharto era, but also during the period of transformation. In East Timor, the most serious human rights abuses took place at the time of a referendum on East Timor's independence from Indonesia, in August 1999. Indonesian military and pro-Indonesian militia murdered some 1,500 civilians, and forced the flight of around 70,000 people. While the United Nations established a hybrid tribunal in East Timor, Indonesia established its own ad hoc tribunal in Jakarta, leaving high-ranking military figures untouched, and convicting only minor militia members instead. However, even they have all been absolved, with the last one, Enrico Guterres, leaving prison in April 2008. The gross human rights abuses that took place during more than 30 years of conflict and occupation in Aceh have hardly any chance of being addressed. The Law on Governing Aceh, signed by the GAM and the government of Indonesia in August 2006, forbids any retroactive prosecution of human rights abuses. Indeed, retroactive prosecution is forbidden on a nationwide basis by Article 28(I) of the new constitution. A law establishing a truth and reconciliation commission was abandoned in 2004, after it was criticized for granting amnesty in return for confessions. Thus there persists a culture of impunity among the military and other key figures. On the other side, activists who try to prosecute the responsible figures face serious danger. One example is the most famous critic of Indonesia's human rights situation, Munir, who founded the Commission for Disappearances and the Victims of Violence (Kontras). He was murdered on a flight to Amsterdam on September 7, 2004. The pilot, a suspected intelligence agent, was initially convicted but then released with all charges were dismissed in August 2008, to the disappointment of human rights activists. A special investigation team failed to collect evidence against any former high-ranking personnel of the National Intelligence Agency (BIN) or the military.

Reconciliation

17 | International Cooperation

Many major reform programs, such as the reform of SOEs, infrastructure reform, and programs on poverty reduction are primarily sponsored by organizations such as the United Nations, the Asian Development Bank and the World Bank. However, international cooperation is still heavily constrained by corruption, an inefficient bureaucratic system and red tape within the implementing organizations. International aid for the tsunami-torn region of Aceh will be completed in 2009, leaving numerous projects incomplete and reconstruction unfinished. Aid programs usually contain conditions aiming at encouraging good governance within organizations and at enhancing the learning process of relevant actors. However, evaluations of aid programs have demonstrated misuse of the assets among bureaucrats as well as on the part of implementing organizations. The government still appears suspicious of donors who are not under its direct control, as can be seen in the new regulation on foreign funding described above.

Effective use of support

Indonesia is a generally reliable member of the international community. Since the mid-1960s the country has close strategic and economic ties with the United States and Western Europe. However, with its Muslim majority, the country is very sensitive to developments in fellow Muslim countries. The recent military actions in Afghanistan and Iraq, as well as the ongoing conflict in Palestine, are thus highly controversial issues in which the Indonesian government has not necessarily adopted the stance of other Western countries. In recent years, the government has become more aware of the dangers of Islamic terrorism, and has acted as a reliable partner in the so-called global war on terror. At the end of 2008, three radical Muslims who were convicted of being part of the 2002 Bali attacks were executed.

Credibility

The government has responded to foreign investors' concerns about corruption and bureaucratic and regulatory hindrances. A set of measures introduced to strengthen the banking industry proved an important step in boosting investors' confidence in domestic banks. Nevertheless, foreign investment is still constrained by the new Investment Law, giving the impression of limited commitment to market reform. Although the government provides an impression of credibility on the international level, corruption is a major constraint in terms of cooperation with donor organizations on the national and local levels.

Migration and forest fires pose severe challenges to relations with neighbors, particularly Malaysia, Brunei and Singapore. Bi- or multilateral cooperation on these issues has proved to be ineffective and prone to short-term concessions. Regional cooperation has gained importance for Indonesia but also faces severe obstacles associated with national politics. The ASEAN Charter, adopted in November 2007, establishes a timeline for a tariff union within the states of ASEAN, therefore enhancing market integration. The charter also identifies human

Regional cooperation

rights and the protection of migrants as priorities, thus putting issues of human development on the ASEAN agenda. In May 2008, 13 Asian states agreed to establish an Asian Monetary Fund, designed to protect against financial crisis and prevent dependence on the International Monetary Fund. The agreed-upon \$80 billion as seed funding will surely prove too little to seriously fight a financial crisis in one country of the region, but nevertheless shows commitment to multilateral cooperation in times of crisis. While Indonesia left OPEC in 2008, since it has been a net oil-importing country since 2004, it is a candidate for the newly founded Gas-OPEC. This organization was founded in October 2008 by Russia, Iran and Qatar, and plans to create a common gas market as well a cartel for gas export.

Strategic Outlook

Democracy in Indonesia has been stabilized, and macroeconomic growth has had a positive impact on the country's overall development. However some serious challenges remain in the near future.

Rampant corruption presents one of the most serious problems in the field of politics and economy. Despite recent government efforts, which have slightly improved the situation, the overall impact of anti-corruption measures has been limited. The government should not underestimate the economic and political costs of this endemic corruption, and should therefore continue and further strengthen its fight. In this regard, there must be particular emphasis on the court system, since corrupt judges endanger the credibility of the whole political system. The fight against corruption has to be taken seriously, and should be adjusted to address the structural nature of the problem. While the powers and budget of the Corruption Eradication Commission (KPK) should be expanded, corruption also has to be fought on the local level. The deterrence effect of public prosecution will not be sufficient to end the culture of corruption.

The huge task of implementing the decentralization process is of utmost importance for the success of the democratization process in general. The economic competition between rapidly progressing regions and less developed areas, particularly in the eastern parts of the country, has led to increasing inequality of living standards. Decentralization has also led to questionable ecological policies in several regions, and corruption is widespread at the local level. In these cases, the national government must take further action to prevent abuse of power and waste of natural resources at the local level, but without re-concentrating power in Jakarta.

The continuing Islamization of the country is a danger for the democratization process, as well as for social peace in this multiethnic and religiously diverse country. The government should hold up the tolerant values of the Pancasila state doctrine and, in cooperation with the courts, abolish discriminatory laws such as the so-called national anti-pornography law and regional Islamist by-laws. International organizations should continue their support for the ongoing democratization process, since Indonesia is not only the fourth most populous country in the world, but also the one with the biggest Muslim population. Establishing solid democracy there could serve as a global example for the compatibility of Islam and democracy.