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The Political Economy of Indonesian Economic Reforms: 1983–2000

BUDY P. RESOSUDARMO* & ARI KUNCORO

ABSTRACT *This paper investigates the political economy behind the three economic reforms in Indonesia, in 1983–91, 1994–97 and the reform under the IMF umbrella immediately after the 1997–98 economic crisis. The prevailing belief is that the Indonesian political economy scenario during those periods closely matched that of Weberian patrimonialism, in which the patron–client system was managed personally by Soeharto. Our findings indicate that, whereas economic reform was possible within the patron–client system in the initial stages of economic reform, this was not the case in later stages.*

1. Introduction

Indonesia achieved independence in 1945; however, in practice, there was not much room to implement any sort of economic development policy, let alone economic reforms, in the following 20 years. This began only when Soeharto came to power in 1966. At that time, inflation ran at 600% per annum, production and trade were stagnant, and the economic infrastructure was in disrepair. Soeharto understood correctly that the key to sustained public support was to fix the economy.

Soon after he became president, he turned to a group of western-trained economists at the University of Indonesia Faculty of Economics to design an economic stabilization policy. A balanced budgetary policy was announced in which the budget deficit was eliminated and the Central Bank was also forbidden to finance it. In the area of the balance of payment policy, multiple exchange rates were abolished and the currency, the rupiah, was devalued to its market value. Foreign trade was liberalized, and to make Indonesia more attractive to foreign investors, a new investment law was decreed, containing generous tax concessions. Close ties with the international donor community were re-established, enabling Indonesia to borrow concessionary loans to rehabilitate its previously neglected physical infrastructure.

Implementation of these policies reduced the inflation rate from 636% in 1966 to 9% in 1970 and generated an average annual growth rate of the gross domestic product (GDP)

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as high as 6.7% during this period. Soeharto was clearly able to turn the economy around and prevent disaster (Thee, 2003). Improving economic conditions throughout the country eliminated tensions among ethnic groups and generated a more solid regional integration.

Maintaining public support by fixing the economy was not Soeharto's only strategy to cling to power—he also created a regime, known as the New Order, based on Weberian patrimonialism (Crouch, 1979). The apparent incompatibility between market-oriented policies and a political structure based on patron–client ties raised doubts (Liddle, 1996). The regime's need for economic growth required bureaucratic values of predictability, regularity, order and rationality, which are the opposite of the nature of patrimonialism, which is characterized by favouritism and arbitrariness. How Soeharto managed these seemingly incompatible forces, reigning for three decades and producing three major economic reforms, is the focus of this paper.

2. Methodological Approach

The purpose of this paper is to investigate three reform periods, 1983–91, 1994–97 and the reform under the IMF umbrella immediately after the 1997–98 economic crisis. With a patron–client political structure, practically all economic reforms in Indonesia in the last 30 years were closely scrutinized by Soeharto before they could become actual policies.

The first hypothesis is that Soeharto's economic policy decisions were influenced primarily by three variables. The most important was economic crisis, which played a substantial role in changing policy, but always in the context of two other factors, namely, ideology and the patrimonialistic nature of the regime. To be implemented, the design of an economic reform needed to meet certain conditions: it had to be persuasive enough for Soeharto; it could not contradict Soeharto's ideological belief; and it could not jeopardize political support for the regime.

Indications that economic crisis is important in inducing policy changes were well documented throughout the 30-year Soeharto regime. The 1983–91 economic reforms were implemented as a response to a crisis caused by a fall in the oil price. The 1994–97 reforms were in response to a crisis associated with the slackening of export and economic growth, and the most recent economic reforms, which were under the umbrella of the IMF's supervision, were conducted in the aftermath of the 1997 currency crisis.

The second hypothesis is that there is, in a way, compatibility between market-oriented policies and patrimonialism in the initial stage of development of a market economy, as shown by the first two major economic reforms. Both economic reform and patrimonialism were the optimal choice for the élite and, most likely, for the rest of the stakeholders.¹ Losers were compensated up front in order not to derail reforms. In the later stage of development of a market economy, market-oriented policy became incompatible with patrimonialism because it slowed reform, as shown in the IMF-sponsored reform. Nevertheless, in reality, abolishing patrimonialism fragmented the political élite. Hence, the ability of political and cultural institutions to gain consensus became limited. Many more interest groups needed to be compensated up front before any programme could proceed.

To be able to test the above two hypotheses carefully, the political structure and important players need to be investigated. For each major reform programme, the analysis focuses on three central questions: (a) Why reforms were conducted (i.e. What were the driving forces of the reforms?) (b) Which factors affected the shape of the reforms

(breadth, scope of reforms, winners, supporters, losers and opponents)? (c) How successful were the reforms?

3. Political Structure and Important Players

Crouch (1979) defined Weberian patrimonialism as a setting in which the government has the ability to rule in the interest of the élite without much concern for the general population because they are on the periphery, presumably poor, socially backward and politically passive. Politics operates only among different factions and cliques within a small circle of the élite. Political competition revolves around gaining favour with the ruler, who determines the allocation of rewards. Soeharto was aided by the fact that after the fall of Sukarno there was a power vacuum. Strong political institutions have never been the hallmark of Indonesia, so it was inevitable in this situation that the personal rule of Soeharto materialized.

Gradually, this personal rule was replaced by the so-called New Order pyramid (Liddle, 1996). Although the president's office was still a domineering force, the structure allowed the involvement of three other important players in the decision-making process: the economists or the technocrats, the technicians and the patrimonialists. The technocrats were a group of western-trained University of Indonesia economists, led by Prof. Widjojo Nitisastro, who embraced the neoclassical view. They were the proponents of conservative market-oriented policies and helped Soeharto in designing the economic stabilization policy in 1966. The economists largely controlled the powerful offices of the Ministry of Finance and the National Planning Agency (BAPPENAS).² The technocrats did not have a large domestic constituency outside the universities and state offices they controlled (Woo *et al.*, 1994).

The technicians or economic nationalists, led by Prof. B. J. Habibie, were mostly engineers-turned-managers with little training in economics, and economists with structuralist inclinations. They were united by their belief in the general validity of the infant industry argument, and thus tended to favour a more protectionist policy and rapid state-led development that usually involved very large capital investment. The technicians controlled the Ministry of Trade, the Ministry of Industry and the National Investment Co-ordinating Board. Their inclination towards a more protectionist industrial policy won them support from indigenous capitalists, army officials and civilian bureaucrats; because of this they were often in direct and fundamental conflict with the technocrats over development policy (Woo *et al.*, 1994).

The patrimonialists consisted of military personnel, élite bureaucrats and the ruling GOLKAR party members. They were in charge of distributing rewards to those within the political élite and possibly to some outside this small circle. At the forefront of this small circle was the civilian bureaucracy. There were various ways in which it could reap rewards from the patrimonialists. This patron–client relationship in the Indonesian civilian bureaucracy was the main root of corruption. These patrimonialist officials were mostly located in the State Secretariat and the administrative area of the presidential office responsible for liaison with the central bureaucracy.

Until 1970, the state oil company, PERTAMINA, was the primary source of presidential financial patronage, and much of this was funnelled through the State Secretariat (Woo *et al.*, 1994). After the mid-1970s, patronage funds also came from other state agencies, such as the State Logistic Agency (BULOG), as well as from the

contributions of Soeharto's business cronies, particularly Sino-Indonesians (McLeod, 2000). Soeharto and his family were known for their connection with Liem Sioe Liong, a Sino-Indonesian businessman, reportedly one of the richest men in the world. This practice also spread to other high-ranking officials who granted cronies lucrative state contracts or opportunities to monopolize businesses in various sectors in exchange for handsome kickbacks.

The general practice of patron–client relationship was as follows. Soeharto gave key government personnel who were loyal to him the opportunity to hold monopolies over information and the authority to grant licences in certain economic activities. This allowed them to sell or grant the information and licences to private parties, in return for substantial financial resources for themselves and the regime. Following Soeharto's example, these key personnel would also distribute the less valuable information and the authority to grant some licences and permits to personnel under their supervision who were loyal and important to the success of their bureaucratic programmes. The distribution of exclusive information and authorities continued right down the line through the government bureaucracy (Seda, 2005). Meanwhile, non-loyalists were economically and politically suppressed and, if necessary, they were violently eliminated.

Soeharto also made extensive use of foundations (*yayasan*) to accumulate wealth both for personal benefit and for the patronage funds. Through a network of such foundations, Soeharto and his family held stakes and a share of profits in dozens of large enterprises, including rice, textiles and flour milling. One advantage of *yayasan* was that they are not subject to auditing and do not have to pay taxes, which was an ideal way to hide excessive personal wealth (McLeod, 2000). The logic of Soeharto was clearly that the sources of presidential patronage money could be better sustained if the economy was growing. An increase in the level of domestic activity and international trade brought about by liberal economic policies could also enhance his political legitimacy (McLeod, 2003).

One powerful institution besides Soeharto himself was the military, because it helped him to secure power after the botched communist coup in 1965 that led to the ousting of Sukarno. Although officially the military, as an institution, stood outside the circle of policy-makers—Soeharto, technocrats, technicians and patrimonialists—it had some influence on the course of policy-making through some of its members holding posts as cabinet ministers. Naturally, the cabinet members from the military tended to ally themselves with technicians and patrimonialists or were patrimonialists themselves. Another important role of the military was that this institution helped Soeharto control regional politics. During Soeharto's era, the majority of regional leaders were retired military personnel (Editor, 1992; Malley, 2003). They were able to suppress conflict among ethnic groups and regions, so that regional politics were relatively stable. Like Soeharto, the military also used *yayasan* for fund-raising (Kingsbury, 2001).

Political organizations were strictly controlled. In 1970, GOLKAR was created from the umbrella of anti-communist groups as “the government party”. All Islamic parties were asked to merge into the United Development Party, known as PPP. Nationalist and Christian parties were grouped under the banner of the Indonesian Democratic Party or PDI. PPP and PDI were the only two legal “opposition” parties that were allowed to contest Indonesia's New Order regime in the national election. From the start, both parties were subject to government interference, even in the choice of the parties' leadership.

In order to mobilize popular support, budgetary allotments were also used to benefit the general population (Liddle, 1996). The price of the staple food, rice, was kept relatively

stable, though largely tracked the world trend. Meanwhile, the government assisted farmers through subsidization of agricultural inputs like fertilizer, seeds and pesticides and the provision of free irrigation. In addition, in times of drought, the state rice procurement agency was always ready to import foreign rice. The subsidy of kerosene eased the burden on urban and rural populations alike. The social capital programme called INPRES was created to improve infrastructure at the village level. Roads, village halls, schools, health centres and markets were constructed in rural areas.

4. Economic Reform from 1983 to 1991

Indonesia grew at an average rate of above 7% in the 1970s. Oil export earning was the main engine for this high growth. However, oil prices dropped in 1982, from US\$37 per barrel in 1981 to US\$34 per barrel. Earnings from oil exports dropped from US\$10.6 billion in 1981/82³ to US\$7.2 billion in 1982/83 (Thorbecke, 1992). The slide in oil prices continued until 1988, with a big drop in 1986. The world price of crude oil dropped from US\$27 per barrel in 1985 to US\$14 per barrel in 1986. Meanwhile, the export price for Indonesia's crude fell from US\$25 per barrel in 1985/86 to slightly below US\$13 in 1986/87 (Woo *et al.*, 1994).

Another blow to the Indonesian economy was the world-wide recession of the early 1980s that also adversely affected the demand for traditional Indonesian exports, mainly agricultural products. The term of trade for the country's non-oil exports fell approximately 12% between 1979/80 and 1982/83, while non-oil export earnings declined from US\$6.2 billion in 1979/80 to US\$3.9 billion in 1982/83. These two external shocks were the driving force of the 1983–91 reform. Their overall impact was that, in 1982, GDP growth rate dropped to approximately only 1% (Figure 1).

The main goal of the reform, hence, was to develop and to diversify non-oil sectors in the economy, particularly manufacturing and agriculture. This reform, or as it was called at the time, economic deregulation—which was implemented through structural adjustment packages—began at the end of 1982. Indonesia adopted a series of measures that had the effect of significantly liberalizing trade, such as simplifying export/import approval procedures, giving exporters greater freedom in the use of their export proceeds,

Figure 1. Annual growth of GDP (in percentage). Source: World Bank Database.

providing subsidized export credit and reducing tariffs significantly across the board. To reduce port charges and processes that mostly related to red-tape activities, the national customs service was disbanded and replaced with a Swiss-based foreign contractor (SGS or Société Général de Surveillance), operating under simplified customs regulations. The rupiah was devalued twice during this period to improve competitiveness. Approval procedures for foreign investments were also simplified. The number of required documents was cut, application fees were discontinued and the typical application processing time was reduced from more than 6 months to less than 2 months.

Throughout the adjustment period, the government's monetary policy was conservative and generally based on maintaining low rates of inflation. A major reform of the banking system was undertaken to oblige banks to follow market principles in attracting deposits and allocating credit. New private domestic and foreign banks were allowed to enter; meanwhile, existing domestic and foreign banks were encouraged to open branches in various cities. A market for corporate bonds was developed. In its fiscal policy, the government undertook major changes in the level and pattern of expenditures and revenues. On the expenditure side, a major budget retrenchment effort was made. However, expenditures on education, health and "other wages and salaries" were cut relatively less than subsidies and capital expenditures on investment projects in the various sectors. Several large public investment programmes were cancelled or postponed. On the revenue side, important reforms in the corporate tax structure and income tax were conducted. A value-added tax replaced an old sales tax system. New property tax (PBB) and income tax were introduced, replacing several previous land and wealth taxes.⁴

Outcomes of the reform were positive. The primary objective of stimulating non-oil exports was achieved in a relatively short period of time. As a percentage of GDP, they grew from 4.2% in the fiscal year 1982 to 9.4% in the fiscal year 1986 and 15.9% in the fiscal year 1989. This brought the share of non-oil exports as a percentage of total exports to around 56.9% in 1990, from 17.8% in 1981. Garments and textiles were becoming the mainstay of manufacturing exports. GDP growth bounced back from as low as 2.53% in 1985 to 7.24% in 1990 (Figure 1). The manufacturing sector, which accounted for only 11.4% of the GDP in 1983 against agriculture's 24% contribution, increased to 19.4% in 1990, which equalled agriculture's share of 19.4%.

In terms of government revenue, the reform was able to reduce the government's dependency on the revenue from oil and gas taxes. The share of oil and gas taxes in the total government revenue dropped from approximately 62% in fiscal year 1982/83 to approximately 27% in 1991/92.

There are several reasons behind the relative success of this reform: (1) the financial liberalization programme led to an increase in banking intermediation, hence making private investment easier; (2) the step-by-step investment and trade liberalization programme not only improved the efficiency of the economy and attracted foreign investors to invest in Indonesia, but also supported national industrial development; (3) two devaluations in the 1980s restored the competitiveness of non-oil tradable goods; (4) tight monetary control kept the inflation rate low, so capital flight was avoided; and (5) the new tax programme increased government revenue, so that government expenditure for the development of infrastructure, education and health could be maintained. Also worth mentioning is the fact that the Indonesian stabilization and structural adjustment programmes in the 1980s were conducted without pressure from the IMF and the World

Bank. The Indonesian government saw that the programmes were needed to solve the crisis.⁵

It is important to observe the politics affecting the shape of the reform. In the decision-making circle, the competition between the economists and the technicians was not openly known, both preferring the appearance of co-operation. In general, the economists were in a stronger position during the 1970s and 1980s, but the technicians had the backing of Habibie, who had quite close ties with Soeharto. During the 1983–91 reform, monetary and exchange rate policies came purely from the technocrat group, but fiscal and trade policies were the result of compromises between these two groups.

With the fall in the oil price, Soeharto's source of income practically dried up, not only for the official budget, but also for patronage, on which he depended for political support. He had no choice but to turn to the economists' prescription to overcome the crisis. Their reform proposal was well suited to Soeharto's overall political strategy. If state revenues could be increased and private sector activity could be rejuvenated to the pre-crisis level, legitimacy and political support would be restored and maintained. Patronage money could flow once again from the private sector.

This time around, economic reform suggested by the technocrats was potentially more difficult for the following reasons. First, after the oil boom, the economic nationalists and patrimonialists were more entrenched. Second, the President's children had now become major beneficiaries of the government protectionist policies, and had become patrimonialists themselves. These two groups, together with the President's business associates, constituted the core interest group. Implementation of the reform reduced the core group's sources of income. However, the core group also knew that Indonesia's having a vast state-dominated economy meant other sources could easily be exploited in compensation. Also, they understood that their prosperity depended on economic recovery.

5. Economic Reforms from 1994 to 1997

The 1994–97 reform had a different driving force than that of the previous reform. There was no looming crisis of the magnitude seen in the 1960s and 1980s, but there was a concern for the apparent slowing down of non-oil exports. The first possible explanation for this slowing down was that the nominal tariff that showed a decreasing trend in the previous period hardly changed at all during the period 1991–94. The same pattern could be observed also for products subject to import licence.

There was also another possible explanation, which was the decline in export-oriented investment. The economy seemed to lose its attractiveness to foreign investors. There was a decline in total outward investment from Japan, one of Indonesia's major sources of investment, and a significant diversion to China. After 1992, the value of new foreign investment continued to fall. In the first half of 1994, for example, the number of approved foreign investments declined by 43% compared with 1992 (Azis & Pangestu, 1994).

In response to this situation, the government announced a bold economic deregulation, mainly related to investment and trade policies, which included the abolition of the limitation on foreign ownership, a reduction of the trade barrier in the form of tariff cuts and the opening up of nine previously closed sectors to foreign investment. The divestment rule,⁶ which had been a major deterrent to foreign investors, was abolished. The deregulation also eliminated the minimum investment requirements, which previously were set at US\$1 million. It also opened up nine sectors previously closed

to foreign investment, which included: sea ports; production, transmission and distribution of electricity; telecommunications; shipping; civil aviation; drinking water; railways; nuclear power generation; and the mass media.

Another trade reform, called the May package, was introduced. The package encompassed a significant and almost across-the-board reduction in tariffs, as well as a pre-announced schedule of further tariff reductions to the year 2003. Further, more transparent tariff surcharge was enacted to replace the remaining non-tariff barrier. The reform, however, was carefully designed to maintain the levels of protection in several industries. For example, the reform eliminated surcharges on 45 tariff lines, including tobacco products, steel sheets and some steel products, but new surcharges of 5–10% were introduced on 69 tariff lines, including steel products, as a way to compensate the steel industry for tariff cuts. Another example was that surcharges were increased for 13 tariff lines, including alcohol-related and petrochemical products, to protect the Chandra Asri Petrochemical Complex, controlled by one of the Soeharto children. The May package also reduced the coverage of import licensing from 242 items to 189, without touching the monopoly and oligopoly rights of BULOG and BPPC (clove buffer stock and marketing board).⁷

Investors seemed to respond favourably to the 1994 economic reforms. This was reflected in the influx of foreign investment in the second half of 1994 such that at the end of the year, the value of foreign investment projects reached its all time high of US\$23.7 billion.⁸ The resurgence of flows of foreign investment continued well into the middle of 1997. Domestic investors also responded positively. In 1994, the value of approved new domestic investment projects exceeded approved foreign investment for the first time.

In the period 1994–96, Indonesia's short-term prospect looked good. GDP grew to average about 8% per annum (Figure 1). However, this growth masked two important developments in the Indonesian economy. First, financial liberalization had attracted a huge capital inflow, in the form of corporate to corporate loans as well as through commercial banking. Second, there was erosion in the fiscal discipline that changed many aspects of economic incentives, including consumption and investment activities. Economic growth actually took place in non-tradable sectors such as residential and non-residential construction, which was intended to meet domestic demand and hence contributed very little to foreign exchange generation. Most capital inflows were used to finance expansion in these sectors. Note that most of these capital inflows were short-term foreign commercial loans.⁹

Political factors affecting this reform were the following. The first half of the 1990s saw the waning of the technocrats' ability to influence Soeharto, either as a group or as individuals. Senior economists such as Widjojo Nitisastro and Ali Wardhana had retired from the cabinet after long tenure, and were replaced by members of the technicians. The change of the balance of power in the policy-making circle, from the technocrats to the technicians, was most likely planned by the President himself. He might have sensed that the time had come for a change in the development strategy, away from the technocrats' comparative advantage, which was based on the free market and the export of labour-intensive products, to a more interventionist industrial policy.

The rising influence of technicians in policy-making caused the growing influence of Habibie, the powerful Minister of State for Research and Technology. To him, economic development was about the physical appearance of the economy, which meant the proliferation of enterprises, which made heavy use of high technology, seemingly

regardless of the impact on national income or its distribution (McLeod, 1993). In contrast to Habibie's views, to most economists, development means increasing income, especially to those poorer segments of the population.

The thinning rank of technocrats and the rise of technicians in the cabinet evidently had significant impact. First was its impact on the government off-budget. The government budget in Indonesia comprises two parts: official and off-budget transactions. While the former was made publicly available, the latter transactions, such as those of lower level government, quasi-government institutions and state-owned enterprises, were unknown. Since there were only a few technocrats in the cabinet, the technicians were able to increase the amount of off-budget expenditures to support "strategic industries" under the control of Habibie. The most publicized case was the use of nearly US\$200 million of reforestation funds for a loan to the aircraft industry to fund the development of a prototype of its 75-passenger N-250 turbo-prop aircraft (Wahyuningsih, *Tempo*, 17 May 1997). Public resources through off-budget transactions were also used to bail out the collapsed state-owned enterprises like BAPINDO in 1994 and firms of politically well-connected groups such as Barito Pacific Timber Company in 1992 (Brown, 1999).

Second was the impact on the nature of economic policies in the 1990s. During this period, macroeconomic policies appeared as market-friendly as ever, but at the microeconomic level they tended to be discriminative. Certainly, there would be no blatant rush to the capital-intensive and high-tech development projects favoured by technicians and perhaps also by Soeharto himself.

6. Economic Reforms under IMF Supervision: 1998–2000

Thailand's economic crisis triggered doubts concerning Indonesia's economic stability. As the direction of capital inflows started to reverse, the external value of the rupiah plummeted between June and November 1997, depreciating by 35%. It became apparent then that the monetary authority did not have sufficient reserves to defend the rupiah. Instead, after increasing interest rates, it opted first to enlarge the band and finally to move to a free float system. Despite high interest rates, capital outflows continued to accelerate and as a result the currency continued to weaken. The move toward a free float created panic among domestic corporations with large exposure to overseas loans, and also international investors with rupiah-denominated assets. Owing to the stability of the rupiah in the past, these debts were largely unhedged. As they scrambled to buy US dollars, it put further pressure on the currency. The currency collapsed from 2300 rupiah in June 1997 to more than 17 000 rupiah per US dollar by January 1998. Following this collapse, inflation in 1998 jumped to 78%.

Although the economic crisis hit Indonesia in the second quarter of 1997, the economy still managed to grow by 4.6% in 1997 (Figure 1). The full impact of the crisis was felt in 1998. The hardest hit was the construction sector, which recorded a negative growth of 36.44% in 1998. The financial sector followed next with a negative growth of 26.63%. The manufacturing sector paid dearly for its high dependency on imported inputs. With soaring production costs due to the mega devaluation of the currency and the collapse of domestic demand, the sector grew by minus 11.44%. The overall GDP contracted by 13.13%.

The socio-economic impact of the currency crisis was transmitted through two channels: (1) decrease in aggregate demands of construction, banking and manufacturing; and (2) increase in prices of imported goods and inputs (Thee, 2001). Between August

1997 and December 1998, the number of non-agricultural employees in the formal sector had fallen by 1.8 million. It is interesting to note that this was accompanied by an increase in employment in the informal sector of 2.8 million. It appeared that those laid-off from the formal sector had been absorbed by the informal sector, which usually involves a movement toward lower quality jobs.

Powerless to deal with the crisis, Indonesia turned to the IMF for assistance in October 1997. In return for a standby loan of US\$43 billion, including US\$12.3 billion from the IMF itself, the government agreed to the comprehensive economic reform programme designed to bring the economy into a recovery path within 3 years. The first programme was the financial restructuring programme, which was aimed at strengthening the weak banking system plagued by large non-performing loans. This step involved the closure of 16 insolvent private banks, including some controlled by Soeharto's family and his business associates. This was a risky strategy because, although it showed the government's adherence to the reform, with no credible deposit insurance scheme, this only made an already panicking public and investors more desperate to abandon the rupiah, pushing the value of the currency further downwards. Stabilization was achieved only after the government announced that it would guarantee all liabilities of the domestic banks.

The second programme was the liberalization of both trade and foreign investment. The medium-term tariff reduction was broadened so that motor vehicles and alcohol products were the only categories remaining outside the general commitment to lower tariffs to a maximum of 10% by the year 2003. The tariff on most chemical products was lowered by 5% at the beginning of 1998, while the maximum tariff on food fell to 5% from the beginning of February. In the automotive industry, special tax facilities enjoyed by Tommy Soeharto's national car company were removed and the local content requirements for the automotive industry were to be phased out in 2 years. In the area of import licensing, the importation of basic food products such as wheat and wheat flour, garlic, sugar and soybeans was opened to general importers. In the same spirit, export taxes on a wide range of products were also removed (Soesastro & Basri, 1998).

In the area of domestic trade, restrictive marketing arrangements for manufactured goods such as cement, paper and plywood, and agricultural goods such as cloves, cashew nuts, oranges and vanilla were abolished, while the control on the pricing of cement was removed. The controversial clove marketing board (BPPC) operated by Tommy Soeharto was also disbanded in mid-1998. In the case of investment policy, restrictions on foreign investment in the palm oil industry were removed in February 1998, and also the long awaited reform in the lucrative wholesale and retail trade sector was commenced with the opening of this sector to foreign investors (Soesastro & Basri, 1998).

In the field of governance, proper bidding processes for government contracts such as infrastructure development, and a more transparent mechanism to evaluate private sector proposals for government projects, were to be adopted. In the case of fiscal discipline, it was decided to consolidate off-budget items spread all over government ministries into the budget. The government also promised to conduct a more vigorous and genuine privatization (McLeod, 1999).¹⁰

Looking at several indicators, by the beginning of 2004 there was no doubt that the economic crisis had bottomed out and the economy seemed to be on the right track to recovery. However, the recovery process is still fragile and there is a danger that it could reverse. Three key stability indicators in the economy have shown encouraging

signs. The contraction of the economy has come to an end, with a modest GDP growth since the first quarter of 1999. The rupiah has stabilized at around 9000 rupiah per US dollar since May 2002. The appreciation of the rupiah, along with the constancy of food supply, has held inflation in check. The inflation rate has been back to one digit since 2000. The rapid decline of inflationary expectation has helped the Central Bank to lower interest rates on SBI (Central Bank Certificate) from a peak of 70% in late August 1998 to below 12% in mid-2003. Since 2000, the economy has been growing at an annual rate of around 4%, but this is insufficient to increase employment or to reduce poverty significantly (MacIntyre & Resosudarmo, 2003).

There has been a growing public perception that the IMF reform programme has not shown much progress in boosting economic growth and creating jobs. Since 1998, the recovery process has been slow and often painful, so that the reform has lost much of its credibility. The legislative body voted in 2002 not to extend the contract with the IMF beyond 2003.

The politics of this reform are as follows. Unlike the economic reforms of 1983–91 and 1994–97, the IMF-sponsored reform in 1998 threatened the dominant position of the core interest group, including Soeharto himself. This reform attached a higher priority to microeconomic programmes reforming industries that had served the supporters of Soeharto very well in the past. Once it became obvious that the IMF-sponsored reform targeted the privileges of Soeharto and the core interest group, it faced strong opposition from the ruling élite, particularly at the implementation stage. It is true that there was never blatant opposition to the reform since Soeharto still needed the IMF umbrella to restore the investors' confidence. However, on several occasions at the beginning of 1998, the President made negative comments about the merit of the reform, and in a way tried to focus frustration with the economic crisis on to the IMF. Soeharto also looked around for other alternatives.¹¹ In March 1998, after his re-election, Soeharto announced a new cabinet in which none of the members of the economist/technocrat camp were appointed, signifying his silent opposition to the reform.

Soeharto made a political miscalculation by underestimating massive unemployment and huge price increases in early to mid-1998 that quickly undermined his performance legitimacy, which had helped him to stay in power for so long. Although people blamed the IMF for the economic hardship caused by the austerity policy, they also began to think of the President himself as detrimental to quick recovery. As the crisis worsened, social unrest continued to spread and the political situation became inflammatory. In May 1998, a massive student demonstration protesting against the fuel price hike turned into large-scale riots, arson and mass looting in Jakarta. In the aftermath of the riot, under the threat of impeachment from no longer compliant leaders of the parliament, Soeharto resigned from the presidency after 32 years in power. The military, whose interest had been sidelined by the core interest group and who faced the prospect of having to quell mass unrest, was only too happy to see the departure of Soeharto, and was perhaps also actively involved in forcing Soeharto to resign.

The resignation of Soeharto made Habibie, who was the vice president at that time, the nation's president. Habibie was powerless. He was pushed into agreeing to conduct a new election after 1 year. The political situation was inconclusive and most people's attention was on the next year's election. The fall of Soeharto thus signified a transformation from an authoritarian regime towards a more democratic society. Much power shifted from the executive body to the legislative body, where the domination of the GOLKAR party was a thing of the past. After the election in 1999, five parties (PDI Perjuangan, GOLKAR, PKB,

PPP and PAN) were competing for the legislative leadership. The growing power of the legislature, without a dominant party, implied that it was harder to arrive at consensus on important matters such as economic policy-making.

It is important to note the changes in business activities after the Soeharto era. The apparent better economic performance of Indonesia in the past, despite the problem of corruption, might be attributed to the fact that Indonesian corruption or rent-seeking activities were centralized and well managed, and thus were more predictable. With the departure of Soeharto, this system has been replaced by a more fragmented system, with at least five dominant parties competing for power and financial resources. The transaction costs caused by corruption, or even in generally conducting business, are now unpredictable.

The other interesting development after the fall of Soeharto is the drive towards regional decentralization. During the Soeharto era, the governmental system was very centralistic. First, almost all decisions at the local level were decided or were strongly influenced by the central government. Regional governments did not have much say about policies in their own regions, though they would have liked it. Second, most revenues from economic activities in the regions, particularly from natural resource extractive industries, were collected by the central government. Although the central government then distributed some of these revenues to regional governments, resource-rich regions, in particular, felt that they should get much more than the amount redistributed to them.

The new atmosphere of freedom created euphoria on the part of local governments (provinces and districts), particularly in the resource-rich regions, and inspired them to demand greater autonomy to manage their own affairs. Habibie had no option but to accept this demand for greater autonomy. In fact, Habibie accelerated the process in the hope that he would gain the necessary popular support to be able to extend his term in office (McLeod, 2005). In 1999, the parliament enacted laws on regional autonomy and on fiscal balancing between the central and regional governments, and in 2001 the decentralization policy was fully implemented. Greater authority was delegated to around 325 districts and 91 cities/municipalities, including the fields of agriculture, industry, trade and investment (Alm *et al.*, 2001).

The immediate impact of the implementation of the decentralization policy was increasing conflict between the central government and the regions, particularly where the central government wanted to keep key responsibilities, and related laws and regulations were not well defined. The second immediate impact was the nature of corruption. It became a more fragmented bribe collection system where central government, ministry, and local government officials and others, like military/police and legislative members, both at the national and local level, were demanding bribes. The third immediate impact was that the decentralization policy created a strong temptation for local governments to raise their own local revenue through various forms of nuisance taxes. These fragmented corruptions, conflicts among levels of government, and the increasing number of regional taxes created serious uncertainty about doing business in Indonesia and, at the end, failed to win back investors' confidence.

7. Conclusion

From observing the political economy of the three reforms from 1983 to 2000, it can be seen that Soeharto's economic policy decisions were influenced primarily by three variables. The most important variable was economic crisis, which played a substantial

role in changing policy but always in the context of the other two factors, namely, ideology and the patrimonialistic nature of the regime. To be implemented by Soeharto, the design of economic reforms had to meet certain conditions. First, it had to be persuasive enough, it should also not contradict his ideological beliefs, and finally it was not permitted to jeopardize political support for the regime.

There is compatibility between market-oriented policies and patrimonialism in the initial stage of development of a market economy, as was shown by the first two major economic reforms. Soeharto believed that, properly managed, a patrimonialistic system built by the combination of military and civilian bureaucratic process was not incompatible with macroeconomic liberalization. Soeharto's political calculation was simply that economic development could serve as an effective legitimizing principle as well as a source of support from many groups, including the military, the civilian bureaucracy and various groups in society. His view of macroeconomic liberalization and patron–client relationships was better demonstrated in the way he handled the conflict between economists and economic nationalists/patrimonialists. While at the macro-economic level he embraced the wisdom of conservative fiscal and monetary policies, he also felt at ease to adopt protectionist policies, especially in the form of special concessions in trade and manufacturing monopolies, credit facilities and government contracts to his closest associates, including Sino-Indonesian, and finally to members of his own family.

In the later stage of development of a market economy, market-oriented policy became incompatible with patrimonialism, as shown by the IMF-sponsored reform. This reform, which was supposed to bring a quick economic recovery, attached a high priority to removing the economic privilege microeconomics that had served the supporters of Soeharto and the core interest group very well in the past. As a consequence, the pace of reforms slowed down because of resistance or foot-dragging. In the end it failed to impress the market and the crisis continued to deepen, with severe output contraction, massive layoffs and increasing absolute poverty. The deepening of the crisis made recovery efforts more difficult; and, after 32 years as the Indonesian president, Soeharto had to step down from this position.

The other interesting development after the fall of Soeharto was the drive towards regional decentralization. Greater authority was delegated to around 300 districts in many areas, including the fields of agriculture, industry, trade and investment. Contrary to the initial goal of the law, i.e. to distribute growth potential to localities, decentralization has created fragmentation of the integrated national economy. Many districts tend to maximize their own tax revenues by imposing barriers to interregional trade, investment, capital and labour movement. Furthermore, corruption and bureaucratic red tape are on the rise. From the political economy's standpoint, decentralization has merely increased the number of interest groups to deal with or to be compensated. As a result of lack of consensus on important economic policies affecting taxation, investment is becoming harder and is taking longer to obtain.

Notes

¹ Since civil society was still too weak during this period, the other stakeholders referred to here are business communities and, in general, government officers, party members and military people.

² The technocrats' grip on these two agencies weakened when, in 1993, Soeharto appointed Mar'ie Muhammad (a career bureaucrat who is close to the patrimonialist group) and Ginandjar Kartasasmita (a patrimonialist) as the finance minister and as the chairperson of BAPPENAS, respectively.

- ³ Before 2000, the Indonesian government fiscal year was from April to March, hence, "in 1981/82" means from April 1981 until March 1982.
- ⁴ See Thorbecke (1992) or Woo *et al.* (1994) for the complete list of 1983–91 reforms. See also Heij (2001) for a detailed analysis of the income tax reform.
- ⁵ The ability to implement the 1983–91 reforms successfully distinguished Indonesia from other petroleum economies, such as Nigeria, which were not able to cope with the price falls during the 1980s.
- ⁶ Divestment in this case is a process in which foreign investors sell their ownership share to their domestic counterpart. The rule was supposedly to boost domestic ownership. At that time, the general rule of divestment was that within 20 years the total foreign ownership in a capital should be lower than 49%, except for export-oriented investments in export processing zones and Batam. It turned out that this policy discouraged foreign investors from entering the country.
- ⁷ See Woo *et al.* (1994) for the complete list of the 1994–97 reforms.
- ⁸ Unlike the previous investment boom in 1988–92, where textiles, garments and footwear made up the bulk of total investment, the second investment boom was more diversified, ranging from electronic components, automotive parts and chemicals, to food and beverages; also, most of the projects were destined to serve the Indonesian domestic market.
- ⁹ An overvalued rupiah and high domestic interest rates made borrowing abroad cheaper.
- ¹⁰ For the complete list of the IMF reforms, see Soesastro & Basri (1998), McLeod (1999) and Hill (1999).
- ¹¹ In early 1998 in the face of the continuously declining value of the rupiah, Soeharto considered applying the currency board system.

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