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18 Half a Century of Indonesian Economic Development: Continuity and Change

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1 INTRODUCTION

Few countries have experienced such dramatic changes in economic fortunes and political governance as Indonesia since the 1960s. The world's fourth most populous nation and the ninth largest economy (in terms of purchasing power parity or PPP), it experienced more or less continuous economic decline for at least half a century prior to the mid-1960s (van der Eng 2002). By then it was one of the world's poorest countries. Two of the most influential studies of that period characterized the country as "a chronic economic dropout", in the words of Higgins (1968), the leading development economics text, and as a country with little prospect of development in the seminal socio-economic survey of Asia by Myrdal (1968).

Then, in a remarkable turnaround, from 1966, the country achieved rapid economic development for the next three decades, such that it was classified as one of the "East Asian miracle economies" in the World Bank's (1993) major comparative study of the early 1990s. A decade and a half later, another World Bank-sponsored comparative analysis, by the Commission on Growth and Development (2008), concluded that, over the preceding century, Indonesia was one of only thirteen economies among the 150 studied to have achieved rapid economic growth for a sustained period of time. According to one analysis, by Australian Treasury staff (Au-Yeung et al. 2014), it may well be the fourth largest economy in the world by 2050.

Indonesia has also had a history of consistently proving the doomsayers wrong. The pessimism of the mid-1960s has already been referred to. Influential theories of economic dualism, backward-sloping supply curves and non-economic behaviour in peasant agriculture originated in colonial Indonesia, famously developed by J.H. Boeke. Yet this was an analytical construct reflecting a system of governance that denied the population political and economic opportunities. Continuing this theme, at the time of the country's sudden independence in 1945, many observers saw little prospect for national unity, socio-economic development, and territorial preservation.

In 1997–98, the third of the key turning points in modern Indonesian development history, this pessimism resurfaced. The country's per capita gross domestic product (GDP) more than quadrupled during the thirty-two-year Soeharto era, resulting in the country's graduation to the middle-income group of developing economies, and seemingly assured rapid, "East Asian style" economic development. But in 1998, during the Asian financial crisis (AFC), the economy contracted sharply, by more than 13 per cent. This translated into one of the largest growth collapses in modern economic history, from peak to trough of about 20 percentage points.[1] This collapse was accompanied by, and in turn triggered, a major political convulsion, with the sudden demise of President Soeharto in May 1998. As in the mid-1960s, the country's prospects were again considered to be exceptionally gloomy. The economy was in free-fall. The value of the currency was at one point just 10 per cent of that pre-crisis. The modern banking system had collapsed. The country's territorial integrity was questioned. Perhaps most importantly, there was no clear process — or historical precedent — for an orderly transfer of political authority.

Yet, as in the mid-1960s, the economy recovered surprisingly quickly, and returned to a moderately strong growth trajectory of 5–6 per cent from 2000. The political transformation was just as remarkable. From three decades of authoritarian, centralized rule — in some respects centred on just one person — Indonesia quickly emerged as Southeast Asia's most vibrant democracy, a status it retains more than a decade and a half after the transition. The country also implemented a "big bang" decentralization in 2001, with the result that much administrative, financial, and political authority has been devolved to subnational governments.

Against this backdrop, we provide an analytical narrative of the country's economic development over this half-century. We first examine economic development, including economic growth, structural

change, and the various social and institutional outcomes, including comparative perspectives and an identification of major development and policy episodes. Next, we seek explanations for these outcomes with reference to the frameworks and methodologies employed in modern development economics. We also focus here on the question of whether there is any "exceptionalism" in the Indonesian record. That is, have its outcomes, patterns, and policy orientations broadly followed development norms, particularly those of the high-growth East Asian economies, as articulated, for example by Perkins (2013)? Finally, we seek to identify continuity and change in policies and outcomes over these five decades, with particular reference to the two major sub-periods, characterized by authoritarian and centralized rule, 1966–98, and democratic, decentralized governance since 1999.

Our organization is as follows. Section 2 investigates economic outcomes, including growth, crisis episodes, structural change, and international comparisons. Section 3 reviews social progress, including poverty, inequality, other social indicators, the labour market, and environmental amenities. Section 4 investigates the key analytical building blocks, what we regard as the proximate drivers of development. These interrelated factors include macroeconomic management, trade and commercial policies, infrastructure, and institutional development. Section 5 summarizes our major findings, and returns to the core question of identifying continuities and changes across and within the two major sub-periods.

It is important to emphasize that the subject matter is so vast as to warrant book-length treatment. Within the confines of a single chapter, we are necessarily restricted to analytics and conclusions at a broad level of generalization. Our list of references is also necessarily limited. The material referred to contains many additional references.[2]

At the outset it needs to be recognized that, although we assert the primacy of domestic economic policies in determining development outcomes, the global and regional environment has certainly influenced these outcomes. It is beyond the scope of this chapter to discuss these external factors in any detail, but a few illustrations are relevant for context. At the most general level, Indonesia has, on balance, benefitted from a reasonably benign and supportive global environment. The first quarter century of Soeharto rule occurred against the backdrop of the Cold War, and with it unquestioning political support (and economic aid) from the United States, and by extension the Bretton Woods institutions. Japan emerged as an economic superpower over this period, and became the country's major trading partner, investor, and donor for some years. More recently, China's strong growth has been unambiguously positive for Indonesia, given the two countries' strong economic complementarity. The agricultural innovations flowing from the Green Revolution greatly assisted Indonesia's efforts to revitalize its food crop sector from the late 1960s onwards (Falcon 2014). More generally, there have been powerful and positive neighbourhood effects from the economic dynamism of the East, and more recently South, Asia, including the stabilizing influence of the Association of Southeast Asian Nations (ASEAN), of which Indonesia is a key member.

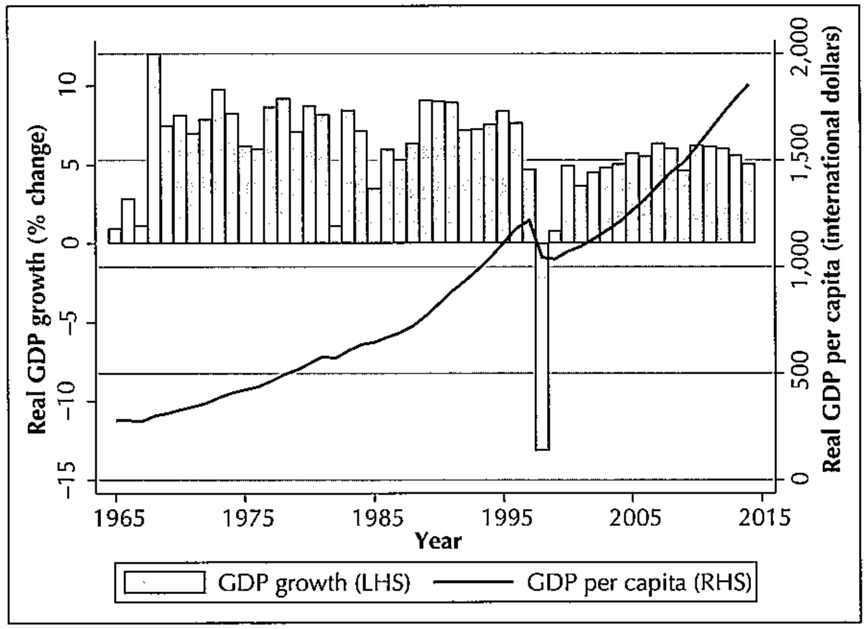
Of course, Indonesia has had to deal with considerable global economic volatility, and this has proved challenging for economic policymaking. As a commodity exporter, its terms of trade have fluctuated sharply, with significant declines especially in the first half of the 1980s and since 2012. Monetary policy in the rich economies has swung from very tight (for example, in the early 1980s) to the very loose current settings, further contributing to capital account volatility for emerging economies like Indonesia. The global financial crisis (GFC) of 2008–9, and its continuing aftermath, resulted in global economic stagnation and considerable investor uncertainty. The Asian financial crisis originated from neighbouring Thailand, but had its origins more broadly in a mix of external and internal factors. Over the course of this half-century, however, the positives have surely outweighed the negatives for Indonesia.

2 ECONOMIC PERFORMANCE

2.1 Economic Growth

The economy responded surprisingly swiftly to the macroeconomic stabilization, economic liberalization, and global political re-engagement pursued by Soeharto and his technocrats. By 1969, the economy was growing at an annual rate of at least 7 per cent. This momentum was maintained through until the onset of the AFC, with an annual average rate of 7.4 per cent (see Figure 18.1). As a result, real per capita GDP rose sharply, by about six-fold, from around US$300 (in 2005 dollars) to US$1,800. Following the AFC, growth resumed by 2000, again surprisingly quickly and averaging 5.1 per cent from 2000 to 2014. Estimates of total factor productivity growth, summarized in Aswicahyono and Hill (2015), present a broadly similar picture, with faster growth in the earlier period, and slower but still positive growth since 2000.

FIGURE 18.1
Economic Growth and Per Capita Income, 1965–2014



Source: World Development Indicators, World Bank.

These outcomes highlight both continuity and discontinuity. That is, the former reflects the fact that growth is the "norm" for Indonesia: remarkably, there has been only one year of negative growth in almost half a century.[3] But there is a discontinuity as well, as indicated by the fact that, since 2000, the country seems to be on a slower long-term growth trajectory. Expressed in per capita terms, the difference is pronounced. Population growth was little changed over this period, at around 2 per cent, and so annual per capita growth declined from 5.4 to 3.1 per cent. In other words, growth per capita since the AFC has been about 60 per cent of that achieved in the Soeharto era. The main explanation must be domestic factors, for at least two reasons. First, the country's per capita income is still well below the point — commonly thought to be in the range US$15–20,000 — at which growth might be expected to slow markedly, as the country approaches high-income thresholds. Second, notwithstanding the GFC, for much of the latter period, the external economic environment has been supportive, particularly with the exceptionally strong, China-driven commodity boom.

2.2 Episodes and Crises

Over this half century, that is, commencing immediately prior to the Soeharto era, Indonesia faced four major economic crises. These were:

- the mid-1960s, an entirely home-grown event resulting from the loss of macroeconomic control amidst political turbulence;
- the early 1980s as the terms of trade collapsed and most developing country commodity exporters experienced a decade of crisis and economic decline;
- the 1997–98 AFC; and
- the 2008–9 GFC and its aftermath.

What conclusions can one draw about Indonesia's capacity for crisis response and management? This, of course, is too large a topic for this chapter, as one needs to analyse each crisis event in detail. However, the key point to emphasize is that Indonesia managed three of the four events effectively. The economic crises were relatively short-lived, and growth resumed quite quickly. The AFC was by far the most serious, accompanied as it was by political collapse, but even here economic growth resumed within three years of the onset of the crisis. This points to a major continuity over the entire period, and one that straddles very different political-institutional settings.

The very different economic outcomes in the two most recent crisis episodes deserve brief comment since both events were "modern" economic crises in the sense that they occurred in an era of global capital market integration and volatility. There are two key questions. First, why did Indonesia experience a catastrophic growth collapse in the AFC, but only a very modest slowdown during the GFC? Second, why was Indonesia the most adversely affected among the Southeast Asian economies during the AFC but among the least affected during the GFC? There is a large literature on both these questions.[4] The short answer to the first question is that Indonesia, like most of its neighbours, was unprepared for the precipitous loss of confidence in the country, its currency, and its banking system. This was the first capital account crisis the country had experienced, and it exposed the fault lines in the recently liberalized financial sector, as well as corporate borrowing excess, and the fixed but adjustable exchange rate regime. Thus, as the capital flight, induced by the contagion from Thailand, gathered momentum, the government was seemingly powerless to take preventive measures to rescue the banks and support the rupiah. The international agencies,

mainly the International Monetary Fund (IMF), misdiagnosed the crisis, further exacerbating the problem. The crisis also triggered the collapse of the seemingly impregnable Soeharto regime. In this respect, Indonesia differed from its two most adversely affected neighbours, Malaysia and Thailand (and also Korea), whose political systems remained resilient.

The crisis of 2008–9 was different in practically every respect. Indonesian policymakers had learnt bitter lessons from the late 1990s. Its financial sector was more cautious and better regulated, with the result that only one minor bank, Bank Century, collapsed.[5] A floating exchange rate regime had been instituted, enabling Bank Indonesia (BI) to allow the rupiah to drift downwards without serious consequences. There was no problem with regime legitimacy; in fact the 2009 presidential and parliamentary elections proceeded smoothly. Externally, Indonesia was buttressed by China's massive stimulus in 2008–9, and the country was less connected to the imploding East Asian production networks.

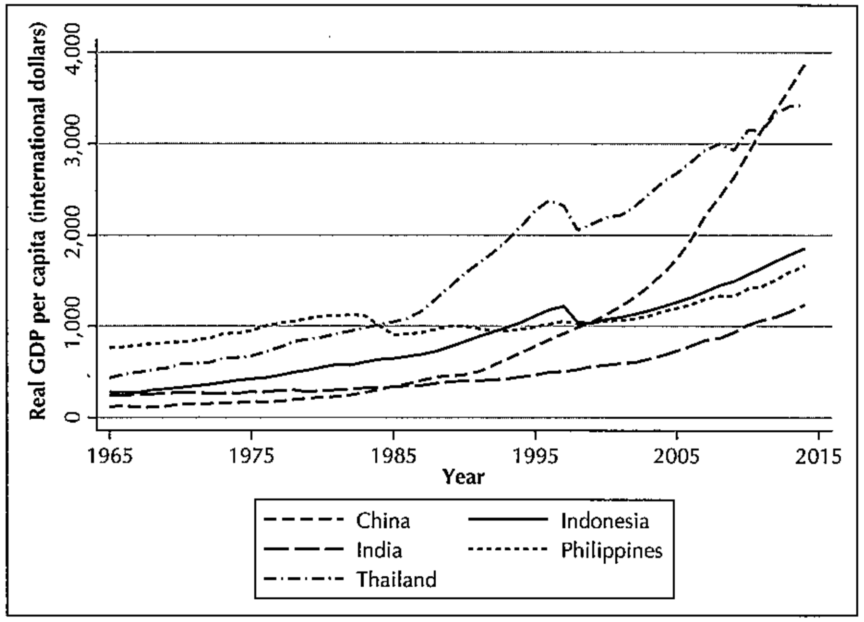
Figure 18.1 also highlights the fact that there were growth episodes within these two broad periods. These episodes generally reflected the interplay of external circumstances and domestic economic policy. Thus growth was rapid during most of the 1970s oil boom decade, but then declined as energy prices fell sharply in the early 1980s. At that time, Indonesia faced difficult economic choices, exacerbated by U.S. monetary policy tightening and the fact that, at home, the oil boom had triggered a return to economic nationalism in trade and investment policies. However, the government responded promptly and effectively to the declining terms of trade with prudent macroeconomic policy and sweeping microeconomic reforms (Soesastro 1989). The result was that strong growth was restored quite quickly.

Unlike practically all other developing country energy exporters outside the Middle East, Indonesia avoided the lost decade or more occasioned by the third world debt crisis.[6] Indonesia then experienced almost a decade of exceptionally strong growth, until the AFC. With the benefit of hindsight, this was also a case of "growing into trouble" (to quote Temple 2003). Soeharto sidelined the technocrats, and supported the fiscally adventurous "technologs", around minister and later President B.J. Habibie. This was occurring just as the egregious corruption associated with the business activities of his children was on the rise, and also as Indonesia was becoming increasingly enmeshed in volatile international capital markets.[7]

2.3 International Comparisons

Extending the previous discussion, it was noted above that over the past half century, the Indonesia growth record is impressive. By this yardstick, it sits within the top decile of developing countries over the past half-century, although since 2000, its performance would have slipped a notch. With the Nigeria comparison of diminished relevance, there are no obviously suitable comparators. The closest regional comparator is the Philippines, owing to its proximity, archipelagic geography, and similarities with respect to ethnic composition and per capita income. The two countries also had very similar political and economic crises, twelve years apart, in the transition from authoritarian, centralized rule to democracy and decentralization.[8] In the mid-1960s, Indonesia's per capita income was well below that of the Philippines. However, by around 1990, it had drawn ahead and, despite its more severe experience during the AFC, it remains so today (see Figure 18.2). It also recovered from its 1997–98 crisis more quickly than did

FIGURE 18.2
Per Capita GDP, 1965–2014: Indonesia and Comparators



Source: World Development Indicators, World Bank.

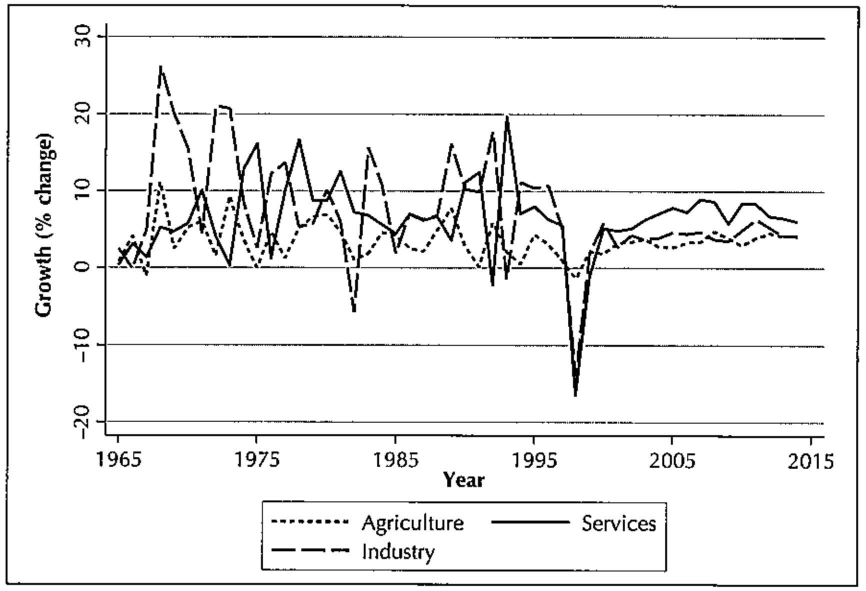
the Philippines from its 1985–86 crisis. Indonesia had returned to its pre-crisis GDP per capita seven years after the onset of the crisis, whereas it took the Philippines twenty years.

Although very different from the other developing Asian giants, they are sometimes used as a comparative reference point. In the mid-1960s, Indonesia's per capita income was similar to that of India and China. By around 1990, its per capita income had drawn well ahead of India and was still slightly higher than China (see Figure 18.2). India was little affected by the AFC and in recent years it has grown very rapidly. But Indonesia's per capita income remains slightly higher. In the case of China, however, its exceptionally rapid growth has meant that its per capita income is now double that of Indonesia. This reflects broader regional patterns, in that Indonesia has not been able to match the performance of the most dynamic East Asian economies (Perkins 2013). Since 1960, per capita GDP in China and the four newly industrialized economies (NIEs) has risen twelve to sixteen times, whereas for Indonesia, the increase has been (a very respectable) six-fold. Malaysia and Thailand have also grown somewhat more strongly, with per capita income rising about eight-fold. Indonesia thus belongs to the Southeast Asian group of moderately strong performers, rather than the East Asian "stars".

2.4 Structural Change and the Sectors

All major sectors have grown throughout the period, except during the AFC (see Figure 18.3). Agriculture has averaged just under 3 per cent annually, with fluctuations driven by seasonal conditions (mainly rainfall) and global agricultural commodity prices. The rehabilitation of the rice sector, driven by both the green revolution and Soeharto's commitment to rural development, provided a major boost to the rural economy (Falcon 2014). Manufacturing grew very strongly throughout the Soeharto era, exceeding 10 per cent in most years. Mining grew strongly in periods of high commodity prices and when there was a conducive climate for commercial exploration and production. Services have grown quite strongly in most years, with volatility occurring during phases of financial and transport sector liberalization and periods of rapid technological change. The one major discontinuity is the slowdown in manufacturing growth. Misleadingly referred to as "deindustrialization" in some quarters, manufacturing has been growing at about 5 per cent per annum since the AFC, less than half the rate over the Soeharto era (Aswicahyono, Hill, and Narjoko 2013). The explanations for this

FIGURE 18.3
Sectoral Growth Rates, 1965–2014

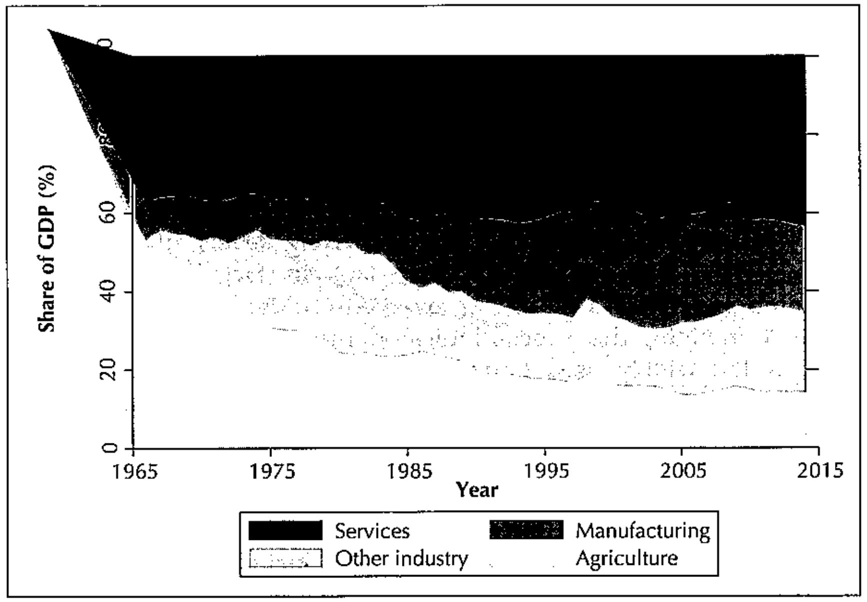


Source: World Development Indicators, World Bank.

slowdown reflect the interplay of several factors: the falling global price of manufactures as a result of China's extraordinarily rapid industrialization, the "Dutch disease" effects of the most recent commodity boom, and a policy environment that hindered the competitiveness of manufacturing. Among the latter have been uncompetitive labour market regulations, poor infrastructure, and an uncertain environment for foreign investors, issues to which we return in Section 4.

Sustained economic growth has had the expected effect of rapid structural change. Agriculture's share of GDP has fallen sharply since the 1960s, from around 40 per cent to a little over 10 per cent, and continuously throughout the period except for a brief reversion back to the farm as a survival strategy at the height of the AFC (see Figure 18.4). The labour market shares have also experienced rapid change, with a lag. For most of the Soeharto era, the industry share rose rapidly, with a trebling of the manufacturing share. Since 2000, the manufacturing share has begun to taper off, and with it the broader industry share.[9] In fact, since 2000, the shares of all major sectors have declined except for services.

FIGURE 18.4
Sectoral Shares of GDP, 1965–2014



Source: World Development Indicators, World Bank.

2.4 Subnational Dimensions

An analysis of Indonesian economic development has to take account of the subnational picture. In the world's largest archipelagic state, there is huge economic, social, and ecological diversity across its thirty-four provinces and approximately 510 *kabupaten* (districts) and municipalities.[10] The richest province has a per capita income about sixteen times that of the poorest, while at the district level, the differential is about 50:1. For a country with an overriding concern about the preservation of territorial integrity, subnational dynamics are arguably just as important as the national record. In this respect, the outcomes are quite positive. Although large differences persist, including especially the pronounced East–West divide, unlike the other Asian giants, China and India, interregional inequality has not increased. In other words, comparing provinces with respect to their initial income (in 1975, when the regional series first became available) and subsequent economic growth, the majority of provinces are located in the two "equalizing" quadrants, that is, with below average per capita income in the initial year but above average growth, or the converse case. The only significant outliers are Jakarta, getting ever richer relative to the rest of the country, and East Nusa Tenggara, continuing to slip behind. Interestingly the major decentralization of 2001 does not appear to have had a major impact on these trends.[11]

3 SOCIAL PROGRESS

At the most general level, social indicators have moved in parallel with economic development. That is, rising levels of per capita income have been associated with, and in fact largely explain, declining poverty, as well as improved education and health achievements. Combining these social indicators into one composite measure, such as the widely used Human Development Index (HDI) points to a similar conclusion. Moreover, in international comparisons, Indonesia's per capita GDP and HDI record a similar ranking, confirming the close interrelationship between the two.

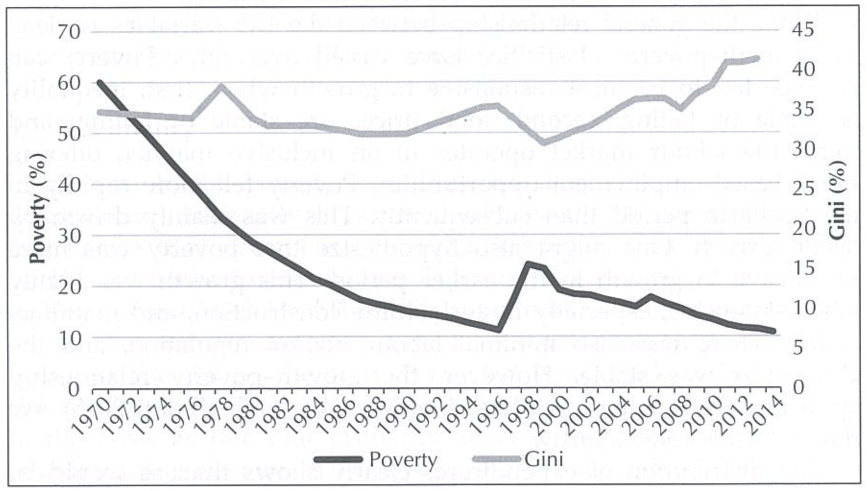
However, the summary HDI conceals as much as it reveals. The various social indicators have not followed the same trajectory. For example, if the state of the environment is included as an indicator of social progress, then there is clearly an inverse correlation with economic growth, as most environmental indicators have deteriorated. The relationship between economic development and inequality is also unclear, with fairly stable inequality for most of the period through to 2000, followed by rising inequality since then. For these reasons we examine the various social dimensions separately.

3.1 Poverty

Trends in poverty incidence are determined jointly by the growth of income and the responsiveness of poverty with respect to income, i.e. the growth–poverty elasticity. The latter can be seen by changes in the distribution of income, which we examine in the following subsection.

As would be expected, according to all measures, poverty has fallen dramatically (see Figure 18.5). This is a key continuity observing the half-century of Indonesia's socio-economic development. According to the most basic indicator, more or less corresponding to "destitution", the percentage of the population below the poverty line, that is, with a measured consumption of less than the arbitrarily defined threshold, declined from over 60 per cent in the 1960s to around 10 per cent. We briefly discuss some of the caveats that need to be attached to this conclusion, but the central point that needs

FIGURE 18.5
Poverty and Inequality, 1970–2014



Source: BPS, Susenas (National Socio-Economic Survey), Jakarta, various years.

to be emphasized is that this is arguably the single most important indicator of the remarkable socio-economic transformation that has occurred in Indonesia since the 1960s.[12]

One difficulty in assessing trends in poverty over this half-century is that the six-fold increase in per capita incomes has resulted in significant changes in community norms as to what constitutes "poverty". In the 1960s, mass hunger was widespread, localized famines were frequent, and "middle class" consumption patterns were confined to a very small, mainly urban, elite. There have therefore been several revisions to the poverty line, to accommodate the large differences in average living standards. These various poverty lines generally have one overlapping year, and therefore, they can be spliced to form a continuous series. However, because the consumption weights vary over time, the resultant continuous series have to be interpreted with caution.

According to much of the prevailing wisdom in the 1960s, poverty was a more or less permanent and immutable state of affairs for Indonesia. However, it actually began to decline quickly with the onset of growth in the late 1960s,[13] and it has continued to decline in practically every period for which there has been positive growth. The principal exception to this story of declining poverty was during the AFC, when the sharp decline in per capita incomes resulted in a short-lived increase in poverty. The close growth–poverty correlation is confirmed by the fact that the country's per capita income and poverty incidence recovered to pre-crisis levels within a decade.

While the general relationship between the two variables is clear, the growth–poverty elasticities have varied over time. Poverty can be expected to be most responsive to growth when, first, inequality is stable or falling; second, food prices are stable or falling; and third, the labour market operates in an inclusive manner, offering broad-based employment opportunities. Poverty fell more rapidly in the Soeharto period than subsequently. This was mainly driven by faster growth. One might also hypothesize that poverty was more responsive to growth in the earlier period. This growth was highly labour-intensive, especially in agriculture, construction, and manufacturing. There was also minimal labour market regulation, and the Gini ratio was stable. However, the growth–poverty relationship appears to have been broadly stable (Manning and Miranti 2015). We return to this issue shortly.

The distribution of expenditures clearly shows that, as would be expected, most Indonesians are clustered closely around the mean. This has three immediate consequences. First, the distinction between being "poor" and "non-poor" for most people is a narrow one. Second, estimates of poverty incidence are highly sensitive to where the (arbitrary) poverty line is drawn. Even very small differences in the threshold can generate very large differences in the poverty estimates.[14] Third, most of the population who are considered to be "non-poor" are precariously so. Sudden food price spikes, a major illness, or a temporary loss of earnings can quickly push these people below the poverty line. The combined effect of these three factors is that there is considerable "churning" in poverty incidence. As Suryahadi, Hadjwidjaja, and Sumarto (2012) show, typically about half the poor in any given year were non-poor the previous year. Fourth, and related, poverty remains a particularly serious problem for those unable to take advantage of the opportunities presented by economic growth. This includes female-headed households, the poorly educated, and those living in poor and remote locations.

At the subnational level, poverty incidence is also closely correlated with per capita incomes.[15] The three richest provinces — Jakarta, East Kalimantan, and Riau — have among the lowest headcount poverty figures. But the relationship is far from uniform. The province with the fourth highest per capita income, Papua, has the country's highest poverty incidence. There are also some very low poverty regions with moderate incomes that are near or below the national income average. Bali is one such example, indicating the

inclusive nature of its development, including its labour-intensive tourism industry. Disaggregating further, to the district-level, a similar relationship is evident, with Papua again the principal outlier. Clearly, resource abundance and the high recorded income it generates is no guarantee that poverty will be overcome.

3.2 Inequality

In contrast to the poverty story, that for inequality is more one of discontinuity, especially between the Soeharto and democratic eras (see Figure 18.5). Except for the 1990s, inequality was broadly stable during the Soeharto era, with a Gini ratio for expenditure generally in the range 0.30–0.33.[16] The 1970s commodity boom resulted in a minor increase in inequality, but it was not prolonged. Inequality began to rise during the early 1990s, but it fell back to 1980s levels during the AFC. This decline is consistent with the characterization of the crisis as one that primarily affected the modern service and manufacturing sectors. In fact, the sharp real depreciation of the rupiah in 1997–98 resulted in strong export growth and earnings for some cash crop sectors, mainly off-Java.

The trend of rising inequality resumed in the early 2000s, with the Gini ratio rising almost 10 percentage points since then, one of the fastest increases observed in the Asia-Pacific region since the 1990s (Kanbur, Rhee, and Zhuang 2014). Along with the slower growth, this is perhaps the major discontinuity between the two periods. It is a trend that has yet to be fully explained, including whether, if at all, democracy has been a contributor.[17]

At least four sets of factors are likely to be at play in this rising inequality. First, labour earnings have probably become more unequal. The labour market regulations introduced since around 2000 have reinforced the dualism that has always been present in Indonesia between the formal and informal sectors. There has also been an increase in a relatively small number of individuals with very high incomes, mainly in the "internationalized" segments of several services industries. The highly restrictive access to the tiny pockets of international-quality tertiary education in Indonesia and overseas has reinforced this inequality. Second, and related, the growth trajectory has become less labour-intensive, particularly in low and semi-skilled manufacturing, thus forcing workers into the lower paid and precarious informal sector. Third, the political commitment to an "egalitarian" development strategy may have waned. There has never been any significant progressivity with respect to taxation policy in Indonesia, but elements of the Soeharto era policy regime —

particularly infrastructure, rural development, education, and Inpres grants (direct grants under the nominal auspices of the president) — were redistributive in their impact. Fourth, and related to the third factor, the benefits of the recent commodity boom appear to have gone mainly to the owners of these resources, and less to the central government. Therefore the pool of resources that might have been redistributed more broadly has been smaller.

Conversely, a mitigating factor since the AFC has been the establishment of a rudimentary social welfare net, with direct grants to poorer households, the targeting of which appears to have been reasonably effective.[18] It is also the case that, as pointed out earlier, spatial inequality has not increased since 2000, in spite of concerns that decentralization would result in a weaker commitment to fiscal equalization across regions.

Pending more detailed analysis and better data, these conclusions remain as conjectures and hypotheses. All one can state with certainty at this stage is that democracy has not led to a more equitable distribution of income. There is certainly no indication that successive administrations in the democracy era have consciously sort to de-emphasize equity objectives. Rather, it is the policy and institutional framework that has had these unintended consequences.

3.3 Education and Health

In the mid-1960s, Indonesia's education and health indicators were among the lowest in the world, reflecting colonial neglect and decades of economic stagnation. These indicators then began to improve

TABLE 18.1
Comparative Health and Education Indicators

	Infant Mortality (per 1,000 live births)		Life Expectancy		Years of Schooling	
	1965	2010	1965	2010	1965	2010
Indonesia	130.6	27.4	48.8	70.2	1.6	7.3
China	84.1	13.5	51.3	74.9	2.1	7.1
India	153.2	46.3	45.1	65.7	1.2	5.4
Philippines	60.2	24.9	59.4	68.3	3.5	8.2
Thailand	86.8	12.5	57.6	73.9	1.9	7.3

Source: World Development Indicators, World Bank and Barro-Lee, available at <www.barrolee.com>.

quite quickly. In the mid-1960s, Indonesians could expect to live for less than 50 years, two-thirds of the population had received no schooling, while more than 10 per cent of babies born would not live to their first birthday. The current figures for these indicators are 72 years, almost universal schooling of some sort for anybody aged less than 50 years, and 22/1,000 respectively (Jones 2015). According to another widely used indicator, the Barro-Lee average years of schooling, Indonesia has increased from 1.5 to 7.3 years.

Although economic growth has been the primary driver of education and health progress, in contrast to poverty, there is a weaker association between these variables and rising per capita incomes. These indicators are slower to change, most obviously because those for older members of the community reflect the conditions of their youth. Moreover, the delivery of these services is more likely to require deliberate government interventions, such as the establishment of schools and health facilities, especially at primary levels of service provision. Teachers, nurses, and doctors have to be trained. Family attitudes, particularly the role of mothers, are also important.

Government policy priorities and impacts have been variable, particularly following the 2001 decentralization, which assigned primary responsibility for the delivery of these services to district governments. The clearest positive commitment has been to quantitative education targets. Universal primary education of sometimes rudimentary quality was by and large achieved by 1980, and by the mid-1990s, this had been extended to junior secondary schooling, that is, nine years of schooling. In 2003, a constitutional amendment was introduced as part of the Law on National Education requiring governments at all levels to spend 20 per cent of their budgets (excluding debt service) on education. The targeting of primary and junior secondary education over higher levels of education, including the tertiary sector, was justifiable on both equity and efficiency grounds. In this respect, also, Indonesia was "East Asian", in contrast to the more unequal education outcomes in much of South Asia. In health, during the Soeharto era, there was major progress in the sensitive area of family planning, in the provision of community health centres (Puskesmas), and immunization programmes. All these contributed to the very large reductions in infant mortality and rising life expectancy, as noted above.

So much for the positives. There have also been notable areas of underachievement, and these have become more evident as the abject poverty of earlier years has been overcome and the country progresses through the middle-income ranks. Three areas have been of particular concern. First, international education quality indicators show that Indonesia lags behind most comparators. According to the two major benchmark series, TIMMS and PISA, Indonesia records one of the lowest scores on English, Maths, and Science, with no indication of improvement, notwithstanding the substantial increase in expenditure. Moreover, post-primary dropout rates are high, and are highly correlated with socio-economic status (Suryadarma and Jones 2014). Indonesian universities also lag (Hill and Thee 2012). Even among Asian universities, the very top Indonesian institutions, at best, are ranked at the bottom quartile of the region's top 100 universities.

In health, Indonesian public expenditure is one of the lowest in the world, while public sector resources tend to be skewed towards expensive modern-sector facilities (Sparrow 2011). Recent initiatives aimed at providing universal public health facilities may be broadening access, at least to urban dwellers in proximity to major hospitals. But the programme has not yet been placed on a secure financial footing, while the necessary supply-side investments prior to its introduction were not undertaken. Not surprisingly, the Indonesian elite has voted with its feet — to access education and health services abroad — in turn compounding the political economy problem of a limited influential constituency demanding improved services. Significantly, democratization and decentralization do not appear to have resulted in any significant improvement in the quality of these services.

3.4 Labour and Wages[19]

Over this period, the labour market has been transformed, as the rapid structural change observed above has impacted on the labour market. In the 1960s, the percentage of the labour force employed in agriculture was about 70 per cent. Since then it has approximately halved, with employment in both industry and services growing rapidly. Over time, the labour force has become better educated, more female, more formal (certainly through to the AFC), and older. Indonesia has also enjoyed the demographic bonus of a relatively youthful population entering the labour force. It has at least another decade before ageing becomes a serious issue (Jones 2015).

During the Soeharto era, Indonesia followed a well-established "East Asian" style of labour market development: although labour associations were suppressed and growth was labour-intensive, there was rapid growth in formal sector employment, and both real wages and productivity rose significantly (Manning 1998). Thus the labour market played a pivotal role in translating the fast economic growth into unprecedented poverty reduction. This labour market flexibility was also important during the AFC. In aggregate, the sharp economic contraction of 1997–98 required a labour market adjustment with both price and quantity dimensions. The more rigid the labour market, the more the effects would be transmitted through quantities, that is, increased open unemployment. The flexible labour market resulted in a relatively small increase in open unemployment but a large fall in real wages, as a result of both stable nominal wages in the presence of high inflation, and reduced hours worked. This "egalitarian" outcome was one explanation for the relatively modest increase in poverty during the crisis.

Democratization introduced a major labour market discontinuity. There was a welcome relaxation of restrictions on labour association, with a result that the number and activities of labour unions increased rapidly. This was accompanied by increasingly "populist" labour market policies, principally with respect to minimum wages and labour severance provisions. The minimum wages, set at the district level, rose rapidly in real terms, especially during the early 2000s, and again in the pre-election period of 2012–13. The severance pay provisions became among the most restrictive in developing Asia, second only to India. Wage growth outstripped productivity, resulting in rising unit labour costs (Aswicahyono and Hill 2015) and weak formal sector employment growth. It also contributed to the indifferent export performance of several traditionally important labour-intensive manufactures. The effect was to accentuate the labour market dualism that has been a feature of Indonesia since the colonial era. As argued above, the schism between the higher-wage formal sector with restricted entry and the large, poorly paid informal sector is likely to have been a contributing factor to the rising inequality since 2000. It has also delayed the onset of the "Lewis turning point" signalling the exhaustion of surplus unskilled labour supplies.

3.5 Environmental Amenities[20]

In contrast to the generally positive socio-economic developments, most environmental indicators have deteriorated. Comprehensive longitudinal data are not available, but the general picture is clear enough. Inexorable population growth — the number of Indonesians has more than doubled over this period — increased environmental impacts in the absence of powerful countervailing protective measures. Estimates of "green accounting" (that is, the exploitation of non-renewable natural resources and adverse health consequences of poor environmental amenities) suggest that these environmental losses are equivalent to at least a percentage point of annual economic growth.

Perhaps the most serious issue is rapid deforestation. Resosudarmo et al. (2012) cite Food and Agriculture Organization (FAO) estimates that Indonesia's forest loss is in the range 0.5–1.5 million hectares per annum in the three decades to 2010. As a percentage of total forested area, this rate is considerably faster than that of other countries with major tropical forests, such as Brazil and the Congo. The destruction of tropical peatlands has also been extensive. The consequences of this deforestation are local, regional, and global. There has been a loss of biodiversity, as the protected habitat for flora and fauna contracts. Natural disasters, particularly floods, have become more serious. The clearing of land areas for agricultural cultivation, particularly lucrative crops such as palm oil, of which Indonesia is now the world's largest producer, has compounded the natural fire conditions. In unusually dry years, typically induced by El Nino weather patterns, such as 1998 and 2015, the resulting haze has spread to neighbouring countries, particularly Malaysia and Singapore. At its peak, these countries' schools and airports have been closed. At a global level, Indonesia has become a major carbon emitter, in years of extensive fire activity, ranking third or fourth in the world.

Indonesia's environmental challenges extend well beyond forest management. Urban amenities have deteriorated, including air quality, green space, haphazard urban planning, and city mobility. Fragile marine resources are also overexploited and endangered by the effects of climate change.

The factors explaining these outcomes are complex and diverse. At the most fundamental level, this is the "environmental Kuznets curve" at work. Societal pressures, institutions, and resources are as yet inadequate, or unaffordable, to enable governments, both national and local, to find solutions to these deep challenges. Property rights are weakly enforced. The incentives to engage in illegal activities, particularly in forestry, are immense, while the constraints on such behaviour remain limited. In the more remote locations, these factors generally operate with even greater force.

The formal policy approach of successive governments has varied. Prohibitions on the export of unprocessed products, most notably logs, have had little, if any, positive environmental impact, while exacting a heavy economic cost. The large energy subsidies over many years have encouraged excessive fossil fuel consumption, compounded also by the inadequate investment in mass transit in urban and densely settled peri-urban regions. One hopeful initiative is

a programme known as Reducing Emissions from Deforestation and Degradation (REDD), which aims to introduce a financial value on carbon stored in forests, through payments offered to governments, companies, and owners of forest land. In May 2010, the Norwegian government pledged US$1 billion, subject to meeting several conditions. Progress to date has been slow, with only US$50 million of the funds disbursed by the end of 2015.

Viewing environmental outcomes over this past half-century, the continuities are more significant than the changes. In particular, democracy does not appear to have had much if any discernible effect. It is certainly the case that environmental defenders in civil society have more space in which to prosecute their causes. Local governments in the major cities of Jakarta, Bandung, and Surabaya have made serious efforts to improve their urban amenities; this was, after all, the most important credential of President Joko Widodo from his earlier periods in local government in the cities of Solo and Jakarta. International collaboration (and pressure) can help at the margins. But the forces opposing better environmental policies remain very powerful.

4 DRIVERS OF GROWTH

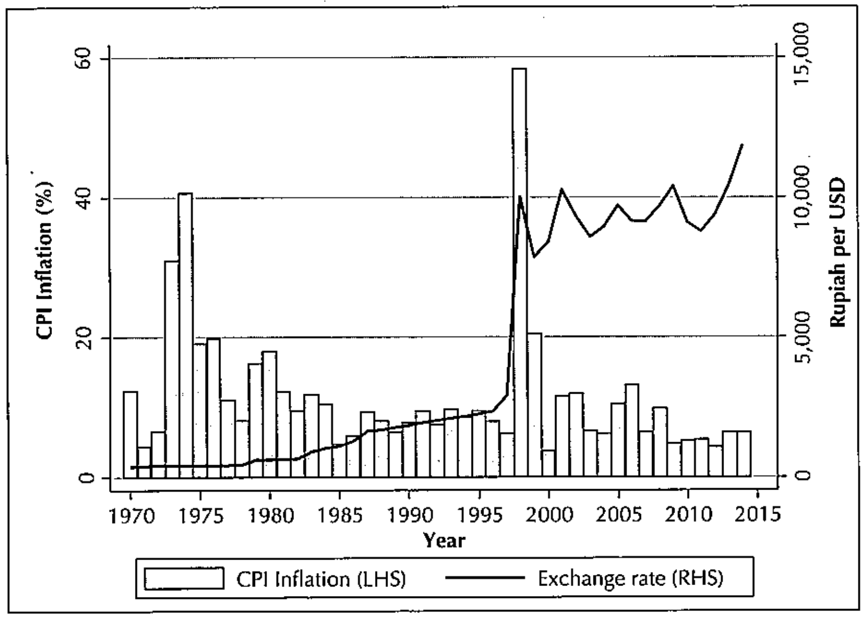
The previous two sections have focused on a broad range of socio-economic outcomes. We now examine the drivers of these outcomes, consistent with an analytical framework in which economic growth is a function of factors that are generally agreed to be the major determinants of international differences in growth rates. These include macroeconomic management, economic openness, institutional quality, and key supply-side factors.

4.1 Macroeconomic Management

Indonesia's macroeconomic management clearly illustrates both continuity and change. The policy modalities, institutions, and instruments have varied considerably between the two periods, but the fundamental priority of moderately strong macroeconomic prudence has remained largely unchanged. This priority is explained mainly by the country's traumatic experience with hyperinflation in the first half of the 1960s, which created an institutionalized inflation-aversion bias ever since. Neighbourhood effects have also been somewhat positive supporting factors, particularly that emanating from Indonesia's three historically well-managed neighbouring economies.

The half-century comprises two distinct policy episodes and one major but short-lived macroeconomic crisis. Inflation was brought under control surprisingly quickly in the late 1960s. The technocrats moved quickly to institutionalize this achievement, persuading Soeharto to introduce the so-called "balanced budget" rule, under which government spending was constrained to be the sum of domestic and foreign revenue. Through to the 1980s, much of the latter was heavily concessional official development assistance (ODA). The result was minimal domestic public debt and generally modest foreign debt. The central bank, BI, operated as an extension of the government, in particular the Ministry of Finance. With an open capital account and a fixed but adjustable exchange rate, monetary aggregates grew rapidly during some periods, resulting in quite high, but manageable, inflation, particularly during the oil boom of the 1970s (see Figure 18.6). The exchange rate was employed proactively to maintain domestic competitiveness, particularly during the large devaluations of 1978, 1983, and 1986. While the first of these devaluations was overtaken by the second round of oil price increases

FIGURE 18.6
Annual Inflation and the IDR/USD Exchange Rate, 1970–2014



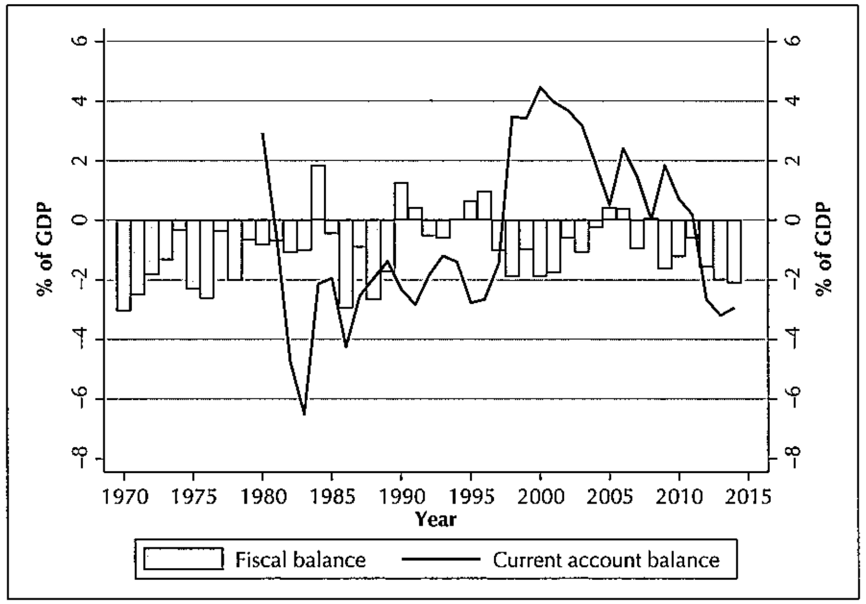
Source: World Development Indicators, World Bank.

and subsequent inflation, the latter two translated into large real depreciations. Indonesia was one of the few major developing country commodity exporters outside the Middle East to avoid a serious economic recession during the 1980s. Sound macroeconomic management was a central contributing factor to this outcome.

These macroeconomic policy settings remained broadly unchanged through to the AFC. BI was essentially targeting a constant real IDR/USD exchange rate by depreciating the nominal exchange rate at a rate sufficient to compensate for the bilateral inflation difference. However, in other respects, the economic and political environment, both at home and abroad, was changing. In 1988, the financial sector was radically liberalized (Cole and Slade 1996). In the early 1990s, capital flows to emerging economies in search of higher yields began to increase rapidly. As we have observed, the 1993 Indonesian cabinet greatly reduced the influence of the technocrats in government. The Soeharto children's business empires expanded rapidly, and their greed appeared to be unlimited. Indonesia's capital account had been open since 1971, but for the first time, there were large flows of short-term, interest-rate sensitive private capital flows. This confluence of domestic and international economic and political factors laid the foundations for the country's deepest economic crisis in its modern history.

Conventional economic indicators appeared sound in the first half of the 1990s: growth was strong, the current account imbalances were modest, inflation was under control, there was no serious exchange rate misalignment, the assessments of the international development institutions and the ratings agencies were uniformly positive. When the Thai financial crisis began to emerge in the first half of 1997, the general view was that Indonesia's "fundamentals" were considerably stronger. However, the contagion spread quickly, and by the third quarter of 1997, Indonesia was being sucked into the crisis. While the initial trigger was capital flight, this was a multidimensional crisis: the exchange rate collapsed, at one stage by as much as 85 per cent. Much of the modern banking sector imploded. There were widespread corporate bankruptcies. There was a temporary loss in macroeconomic control, mainly resulting from the blank cheque provided to recapitalize the banking sector. Unlike the three other Asian economies in crisis, Indonesia also experienced a regime crisis. The macroeconomic balances reflected the various elements of these interrelated crises. The current account swung from a modest deficit to a large surplus, while the fiscal account swung from a balanced budget to a large deficit (see Figure 18.7).

FIGURE 18.7
Fiscal and Current Account Balances, 1970–2014



Source: IMF and Mauro et al. (2013).

However, Indonesia and its neighbours recovered surprisingly quickly from the crisis. Central to this recovery, and subsequently the management of the 2008–9 GFC, was the restoration of macroeconomic control. From 1998 to 2004, Indonesian economic policymaking operated under the auspices of a deeply unpopular IMF programme, which in turn facilitated emergency financial support. As part of this programme, BI became an independent agency, and a new floating rate and inflation targeting regime was instituted. To expedite the exit from the programme, the 2003 Fiscal Law was enacted, embodying the European Union's (EU's) Maastricht principles that capped fiscal deficits and public debt at 3 per cent and 60 per cent of GDP respectively. Unlike the EU, Indonesia has adhered consistently to these principles. Combined with the restoration of economic growth and modest asset sales, public debt has fallen sharply, from about 100 per cent of GDP in 2000 to the current figure of about 25 per cent. As in the late 1960s, this has been a successful episode in macroeconomic consolidation in the face of seemingly desperate circumstances. It confirms Indonesia's reputation as an effective macroeconomic crisis manager.

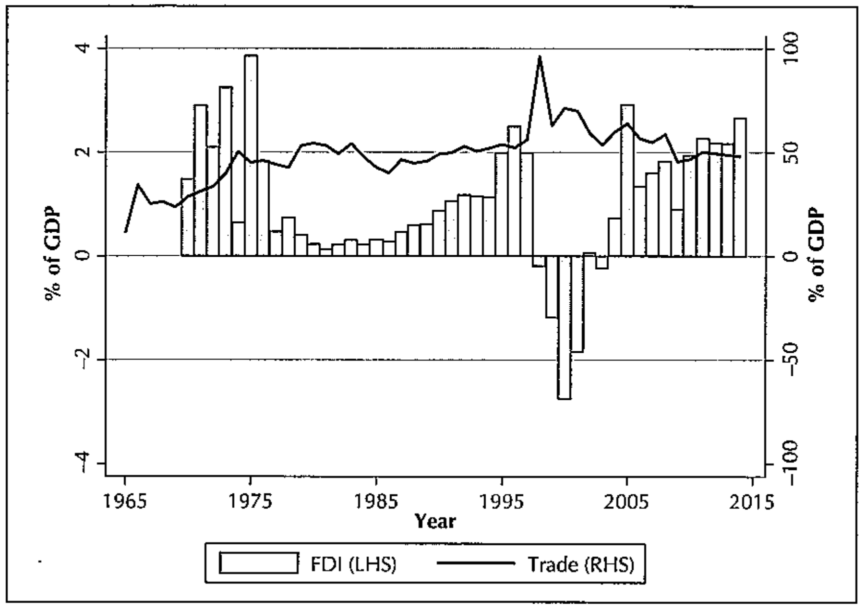
4.2 Trade and Commercial Policy

The continuities also feature prominently in trade and commercial policy. In its international orientation, Indonesia has ranged across the spectrum from isolation and disengagement to highly open economic policy settings. Underpinning these variable outcomes has been the interplay of two broad influences. On the one hand, there is an enduring and widespread community distrust of globalization and economic liberalism. But on the other, there was the disastrous experience of turning inwards during the 1950s and early 1960s, combined with the pragmatic reality of outward-looking East Asian economic integration, including also Indonesia's commitments to its ASEAN neighbours. The country's location in the midst of several very open and successful economies, and the presence of extensive informal trade flows, have also served as a practical constraint on the imposition of high trade barriers. The result has been that, for most of the period, Indonesia has been moderately open, if somewhat uneasily so.

During the Soeharto era, trade policy outcomes varied depending on which group of policy actors was in the ascendancy — the technocrats and donors broadly favouring an outward-looking strategy, or the nationalists (and associated rent-seekers) supporting a more interventionist approach (Basri and Hill 2004). Figure 18.8 provides summary proxy indicators of revealed trade and investment openness.[21] Facing parlous economic circumstances and intent on rejoining the Western community, the government adopted very open trade and investment policies from 1967. As economic growth was consolidated and the oil boom conferred hitherto undreamt of financial resources, nationalist sentiments resurfaced, and the trade and investment regime became increasingly restrictive from the mid-1970s. By then, the technocrats had become increasingly marginalized in trade and microeconomic policy, and they were able to regain policy influence in this area only after the sharp decline in international oil prices threatened growth and macroeconomic stability almost a decade later. The major trade and regulatory reforms that followed from around 1984 reaffirmed the validity of what became known as "Sadli's Law", referred to earlier.

Perhaps surprisingly, Indonesia did not turn inwards during and after the AFC. The IMF programme was one obvious constraint, but there were other factors at work. As in the 1960s and 1980s, the crisis empowered the technocrats, at least through the Ministry of Finance. The large currency depreciation ameliorated some of the pressures for protection. No other countries in the neighbourhood turned inward; indeed, the two developing Asian giants, China and India, continued to reform.

FIGURE 18.8
Trade and FDI as Per Cent of GDP, 1965–2014



Source: World Development Indicators, World Bank and UNCTAD.

However, as in the 1970s, the pendulum began to swing back towards greater interventionism as the commodity boom of the 2000s developed. This led again to intensified protectionist pressures and a more restrictive approach towards foreign investment. One might have expected the democratic processes to introduce a new element of political lobbying for trade protection. While some such elements have emerged, the traditional bureaucratic battlegrounds have remained important, with the line ministries, agriculture and industry in particular, a conduit for business interests seeking protection, in opposition to the economically more literate cabinet members.[22] At the margin, the latter group has been able to invoke regional and global trade policy commitments. Whether the earlier relationship between the country's terms of trade and trade openness still exists remains to be seen. The declining terms of trade from around 2013 appears to have halted the trend towards increasing economic nationalism, but a major reversal is not yet evident. The series of packages released from September 2015 are, at least, a hopeful beginning.

While trade policy formulation and outcomes have not changed significantly across the two eras, the investment climate and regime have become considerably less certain and predictable. The main driver of this change has, of course, been the diffusion of political power, and therefore rents, both within the central government and between the central and local governments. That is, whereas the allocation of rents was tightly controlled and centralized during the Soeharto era — with the Soeharto family, its close associates, and the military the principal arbiters — the more diffused and open political systems since 1999 have reshaped the business environment. Alongside some of the more durable Soeharto-era businesses, such as the Salim and Riady groups, new Jakarta-based actors have emerged, while regional power brokers have become increasingly important, particularly in resource-rich regions. Moreover, as discussed further below, in contrast to the well-defined rent extraction procedures during the Soeharto era (who to pay, how much, and for what expected returns), the plurality of actors and the fluid state of central-local government relations has introduced considerable uncertainty into the business environment, especially for foreign investors.[23]

4.3 Institutions

Institutions are at the heart of economic development, for overcoming market failures, protecting property rights, providing more equitable social outcomes, mediating conflict, and as insurance against catastrophic risk. Institutional development in Indonesia is still in its infancy, suppressed by centuries of colonialism, flowering briefly during the chaotic years of early independence, suppressed again during the Soeharto era, and then suddenly provided with the democratic space to develop again after 1999. If Soeharto was the institution through until 1998, how would one characterize institutional development since then? The most important institution of all is, of course, the democratic expression of the populace through an open, contestable and legitimate electoral process. In this respect, Indonesia has performed remarkably well, better than even the most optimistic observers could have dared to hope for in the late 1990s.[24] Owing to the complexity and breadth of the subject matter, we confine our brief analysis of institutional change in five key interrelated areas of economic policymaking.

Macroeconomic policy institutions: As noted above, a democratic Indonesia has achieved reasonably effective macroeconomic outcomes.

This has been facilitated by the introduction of certain formal institutional innovations. The most important of these have been an independent charter for BI, with clear performance criteria with regard to inflation, and the 2003 Fiscal Law, which has provided legislative protection for the Ministry of Finance. The technical expertise within these institutions has also been raised, although the ongoing reform agenda remains a large one, especially with regard to tax effort and procedures, and the quality of spending (including large, ill-directed subsidies, which the Widodo administration has begun to reform). In the wake of the AFC, the government has also made a determined attempt to strengthen the regulation and supervision of the financial system.

The bureaucracy: During the Soeharto era, the bureaucracy was subservient to the executive, and with few exceptions, it remained largely unreformed. It might have been expected that a newly vibrant democracy, a vocal civil society, and an assertive legislature would demand higher standards of bureaucratic accountability and performance. But with few exceptions, bureaucratic reform has proceeded very slowly, and many of the enduring challenges remain (McLeod 2005). These include a stronger link between performance, remuneration, and promotion; employment conditions that more closely match those in the private sector; greater inter-agency mobility, including the capacity to recruit from outside the civil service at all levels; a careful examination of staffing requirements; and a simplified single-line salary structure.

The slow pace of bureaucratic reform, reflecting both inertia and deliberate rent-seeking, is further revealed in the complexity of the country's regulatory and licensing regime. In spite of numerous attempts to streamline business regulations and procedures, Indonesia still ranks rather poorly on various comparative and most subjective indicators that attempt to measure and rank government efficiency and ease of doing business. Regulatory complexity and opaque salary structures, in turn, act as powerful incentives to engage in corrupt activities. We return to some of these issues shortly with reference to checks on corruption within the public sector, and the decentralization of many government activities.

The legal system: During the Soeharto era, the legal system was largely dysfunctional and subject to political direction in important cases. But the institutional arrangements governing the protection of property rights were more or less predictable. There was very limited recourse to the commercial courts, for example, with firms preferring

to enlist the support of powerful backers, drawn mainly from the senior echelons of the military through to around the mid-1980s, and from among the Soeharto family in its last decade of power. Businesses paid a "tax surcharge", in exchange for protection and an accommodating commercial environment, in the context of rapid growth. Investors and creditors have, therefore, traditionally had little faith in resolving disputes through formal legal mechanisms in Indonesia (Lindsey 2004).

Inevitably, legal reform is a slow and complex process. Judges are career appointments, whereas in most modern legal jurisdictions, they are appointed from the legal profession, based on experience and reputation, and are adequately remunerated. In addition, the commercial courts, which were initially regarded as an opportunity to overcome corruption and incompetence in bankruptcy cases, have proved to be disappointing. Very few international investors resort to these courts. In these circumstances, foreign investors have to enter the country with the knowledge that they have little legal redress against delinquent domestic debtors.

Corruption: A major policy innovation during the democratic era has been the establishment of the KPK, *Komisi Pemberantasan Korupsi*, or Corruption Eradication Commission, which is now the most popular national institution in the country. Signed into law in late 2002 and operational from late 2004, it has the authority to investigate and prosecute cases of more than IDR1 billion and involving members of law enforcement agencies and other state officials, as well as parties linked to them. Its powers are extensive, including being able to tap telephones, ban overseas travel, freeze bank accounts, and obtain information from financial institutions.

Most assessments of its operations are broadly positive (Crouch 2010). One indicator of the KPK's success is the increased hostility towards it from within the parliament and bureaucracy in recent years. There have also been attempts to directly weaken its powers, for example with the Dewan Perwakilan Rakyat (DPR; People's Representative Council) seeking to influence which cases it may examine, and by changing the personnel at the top. A particular strength of KPK has been its ability to bypass the corrupt general legal system, i.e. by excluding ordinary law enforcement institutions from handling particular corruption cases, either by initiating an investigation itself or by taking over a case.

Nevertheless, corruption appears to be as endemic as ever (Butt 2015). Klitgaard's memorable phrase remains apposite: "corruption equals monopoly minus accountability plus discretion". Pressures for accountability have certainly increased. However, the slow pace of bureaucratic reform, particularly with regard to the complexity of administrative procedures, licensing requirements, and the structure of civil service remuneration, continue to provide powerful incentives to engage in corrupt practices. It is also arguably the case that, in contrast to the "organized corruption" of the Soeharto era, much of the corruption is now somewhat "disorganized", in the sense that the fluid and diffused centres of political power have resulted in many more policy actors and, therefore, less certainty concerning bribery payoffs and practices.

Decentralization: Indonesia hastily introduced a big bang decentralization package on 1 January 2001. About 35 per cent of central government revenue is now transferred to district governments, most of it in the form of direct, formula-driven block grants. These local governments are now responsible for most local-level services, including much of education, health, and infrastructure. The expected outcome from such a reform is that local services will improve, because legislators are closer and more responsive to their constituents, and because there will be increased subnational competition for footloose capital and labour. A decade and a half later, these regional governance arrangements are still in transition.[25] The record to date is mixed. The new system is certainly functional, and it is probably the case that some local-level business licensing procedures have improved. Local democracy is fully functional, local reform champions have emerged, and the system now provides a new pathway to national politics, as illustrated in the ascendancy of President Widodo. Moreover, if the primary aim of decentralization was to forestall a feared territorial disintegration, then it must be judged a success.

However, apart from a small group of notable exceptions, there is limited evidence of any broad-based improvement in local services. Indeed, infrastructure quality has arguably deteriorated, as many local governments have displayed a propensity instead to expand their administrative staffing and amenities. A major complication has been the fragmentation of administrative boundaries. The number of districts has almost doubled since the late Soeharto period, driven by the implicit fiscal incentives that reward the creation of new administrative units.

4.4 Infrastructure

By the mid-1960s, every aspect of Indonesia's physical infrastructure was in a dilapidated state (McCawley 2015). Colonial era investments

focused on servicing the requirements of the modern export-oriented enclave economy. During the first two decades of independence, economic decline and recurring fiscal crises resulted in very little infrastructure investment. By contrast, the Soeharto administration accorded a high priority to physical infrastructure, and as a result the country experienced its first ever period of broad-based investments in roads, ports, airports, and telecommunications. By every indicator, the expansion was impressive.

However, successive democratic administrations have under-invested in infrastructure. Indonesia is therefore facing a severe infrastructure deficit. As a percentage of GDP, the country is now spending little more than half of that in the Soeharto era or in Asia's high growth economies. It lags behind its middle-income neighbours on practically every infrastructure indicator.[26] This constrains economic growth. It hurts both the rural poor, who particularly depend on rural roads and irrigation for their productivity and markets, and the urban poor, who face daunting commuting times in substandard transport facilities. The initial explanation for this underinvestment was the fiscal crisis of 1997–99, during which the government reduced its development and capital budget severely. However, low levels of spending now appear to have become institutionalized in the country's political economy, and this marks a significant discontinuity between the two periods.

The political complexities to overcome these problems are immense, as all five potential solutions to the problem will face concerted opposition. First, there needs to be more public funding, which has to come from both more efficient spending (especially lower subsidies) and higher taxes. Second, the local governments, which now have greatly increased revenue, need to be induced to spend more of their allocations on infrastructure rather than enlarged administrations and accumulated reserves. Thirdly, the state agencies responsible for harbours, ports, and toll roads need to improve their efficiency, including crucially being forced to operate in a more competitive environment. Fourth, further deregulation is essential, akin to the highly successful domestic civil aviation reforms of 2002. And fifth, populist price caps that deter international infrastructure providers need to be removed. Without these reforms, the various master plans and infrastructure summits will likely achieve little.

5 SUMMING UP

Contrary to the prevailing pessimism at the three key junctures of its history – 1945, 1965–66, and 1997–98 – Indonesia has achieved half a century of rapid socio-economic development. This analytical survey has examined both the outcomes and the drivers of this record, and also explored whether and how the sudden transition from three decades of authoritarian rule to an open, pluralistic democracy has impacted on development trajectories.

The major continuities throughout the entire period are moderately rapid economic growth and structural change, a rapid reduction in poverty incidence, improving social indicators, reasonably prudent macroeconomic management, including especially crisis management, pragmatic if ambivalent global and regional economic engagement, and reasonably broad-based spatial development. These factors, in turn, explain much of the continued economic growth throughout both periods.

What of the differences between these two periods; and in particular, has the transition from authoritarian to democratic rule had significant development impacts? We have to be cautious in making strong generalizations. Two-variable analysis in a multi-variable world of complexity is a hazardous exercise. Nevertheless, some general conclusions with plausible causality can be stated. First, economic growth has been significantly slower, about two percentage points, in the latter period. Second, the sectoral drivers of growth have changed, with manufacturing in particular growing at about half the rate recorded during the first period. Third, after a long period of relative stability, inequality has increased significantly. Fourth, the new system of governance has struggled to manage investment projects with long and/or uncertain returns, particularly in infrastructure but also mining.

The formal institutions of governance have changed fundamentally. Indonesia is the most vibrant democracy not only in Southeast Asia but arguably also in the Islamic world. More people vote in the country's presidential elections than in any other democratic election for a country's leader. Subnational elections occur for leaders and assemblies at the more than 540 subnational provinces and districts, in addition to the leaders of some 74,000 villages. The president appoints the cabinet, but ministers are just as accountable to the parliament, to their parties' constituencies, and to civil society.

Yet in other respects, there are marked institutional continuities. With a few notable exceptions (for example, the establishment of independent commissions and BI independence), the bureaucracy is largely unreformed. The regulatory and licensing regimes are as complex and impenetrable as ever. Corruption remains an ever-present concern. The judicial system is now formally independent of the executive but outcomes are unpredictable and the protection of property rights remains weak.

One significant difference relates to the political economy of policy reform. During the Soeharto era, such was the concentration of power around the presidency that all major economic decisions required his approval. On balance, this worked well for the country. As shown above, when the technocrats were in the ascendancy, and they were able to convince the president of the case for change, reform proceeded rapidly. Conversely, business interests close to Soeharto benefitted egregiously, and deeper institutional reform was suppressed. During the democratic era, a more developed institutional framework has guided macroeconomic policy, principally through the fiscal law and an independent central bank. But in other respects, owing to the diffusion of political power, reform has proceeded more slowly, and erratically. Some key ministerial appointments have made a difference, but there is no consistent pattern in the factors driving these appointments. Policy advocacy and community education have become more important means of effecting change, but these are long-term processes with uncertain payoffs.

Notes

1. That is, from the average annual growth of about 7 per cent during the preceding decades to the 13 per cent decline.
2. Our most important source of information is the *Bulletin of Indonesian Economic Studies*, published on a four-monthly basis since June 1965, and in particular, each issue's "Survey of Recent Developments". See also longer-term studies of the economy such as Booth (2016) and Hill (2000). Two Australian National University (ANU)-based edited volumes examined Soeharto era development in great detail: Booth and McCawley (1981) through to the late 1970s and Booth (1992) through to the early 1990s.
3. That is, for the period 1967–2015. Although the AFC hit Indonesia in mid-1997, growth was strongly positive until about August that year, resulting in positive growth for the calendar year. The official national accounts statistics record 1999 as a year of zero (but not negative) growth. In 1984, as oil prices collapsed, growth was either slightly positive or negative depending on which base year is used for the national accounts.
4. On the AFC, including Indonesia in comparative analysis, see for example McLeod and Garnaut (1998) and Arndt and Hill (2000). Basri and Hill (2011) compare and contrast the Indonesian experience in the two crisis episodes.

5. Nonetheless, the bank collapse and subsequent rescue operation had devastating political consequences, contributing to the exit of a highly regarded Finance Minister, and indirectly setting back the cause of economic reform.
6. Malaysia was also among the small group of exceptions to avoid a deep crisis, and for similar reasons to Indonesia. This was also the period when Indonesia and Nigeria parted company. During the 1970s, Nigeria was arguably the closest comparator country for Indonesia — a populous, low-income, resource-rich, ethnically diverse tropical economy. Around 1970, Nigeria was ahead of Indonesia on most indicators, marginally in its per capita income, significantly with respect to human capital. By the 1990s, Indonesia's per capita income was more than double that of Nigeria. For the Indonesian story in comparative context, see Gelb and Associates (1988) for a study of the major developing country commodity exporters, and Bevan, Collier, and Gunning (1999) on the Indonesia–Nigeria comparison.
7. The implied inverse correlation between the terms of trade and the "quality" of economic policy was first systematically explored in Chatib Basri's (2001) PhD dissertation (cited in Basri and Hill 2004), with particular reference to trade policy. During the Soeharto era, the phenomenon came to be known as "Sadli's Law", a reference to the famous technocrat who is widely credited as the originator of the formulation that "bad times make for good policies and good times often the reverse". Whether this relationship has persisted through into the democratic era remains to be seen. Since the decline in the terms of trade commencing around 2012, there is, to date, only limited evidence of a commensurate policy response. (See Patunru and Rahardja 2015 for an early view suggesting that the relationship has weakened.) Nevertheless, the policy response to the falling terms of trade in the early 1980s lagged by several years, and so it is too early to make definitive judgements.
8. That is, the Philippine economic crisis of 1985–86 was very similar in origins, magnitudes, and policy responses to Indonesia's crisis of 1997–98.
9. However, on a comparative cross-country basis, Indonesia's manufacturing share is still larger than what would be expected on the basis of its per capita GDP (Aswicahyono and Hill 2015).
10. As noted below, the number of provinces and *kabupaten* continues to increase, as the splintering of units progresses unabated.
11. The data in this paragraph are from Hill and Vidyattama (2014). A broadly similar conclusion applies if the unit of analysis is districts, although in the latter case, the empirics are greatly complicated by the extensive fragmentation of boundaries, a process known as *pemekaran*.
12. The literature on poverty in Indonesia is voluminous, reflecting both the interest in the subject and the quality and accessibility of BPS data. Two major recent studies, that also include references to much of the earlier work, are Manning and Sudarno (2011) and World Bank (2015). See also the source material referred to in the references in footnote 1.

13. There are no reliable poverty estimates for the pre-1965 period that are directly comparable to those of the post-1965 period.
14. For example, as the World Bank (2015) shows, in 2014 the percentage of the population in poverty (with daily expenditure below PPP US$1.30) was just 11.3 per cent, the percentage of the population considered "vulnerable" (with daily expenditure in the range PPP US$1.30–1.90) was 26.9 per cent. Employing the commonly used international benchmark of US$2 per day pushes the total to over 40 per cent.
15. The analysis in this paragraph draws on Hill and Vidyattama (2014) and Ilmma and Wai-Poi (2014).
16. A brief note on the inequality data is relevant here. They are generated from the BPS household income and expenditure series, known as *Susenas*. BPS is widely regarded as a professional and independent agency, but as with other developing countries, the data are subject to the usual caveats. The most reliable data refer to expenditure. Income data are limited in scope and quality; wealth data are practically non-existent. There is thought to be considerable understatement at both the top and bottom ends of the distribution. The understatement at the top is thought to be increasing over time, as revealed by the fact that aggregate personal consumption expenditure as a percentage of the figure reported in the national accounts is declining, and is now less than 40 per cent.
17. World Bank (2015) and associated background papers by Matthew Wai-Poi and colleagues provide the most thorough examination of these trends.
18. World Bank (2015) compares the before and after (government transfers) distribution of Indonesia and other middle-income developing countries. The large Latin American countries, such as Brazil and Mexico, have more unequal pre-government distributions than Indonesia, but the redistributive impacts of their social policies are also larger. It is not possible to undertake this type of analysis for the Soeharto era.
19. This subsection draws extensively on the writings of Chris Manning. See in particular Manning (1998), Manning (2014), and references cited therein.
20. The following paragraphs draw, in particular, to two recent authoritative papers by Resosudarmo et al. (2012) and Shively and Smith (2015), together with references cited therein.
21. There are the usual caveats in interpreting these data as indicators of policy openness: exports are influenced by commodity prices, the slicing up of international trade overstates the true trade exposure, FDI projects tend to be lumpy, especially in the natural resource sector.
22. The Department of Agriculture has emerged as the most powerful and effective voice for protectionism, and many of the rising trade barriers are in this sector. An able trade minister, economist Dr Mari Pangestu (2004–11), was able to block some of these protectionist pressures. Her replacement by more nationalist ministers at the peak of the commodity boom was a factor in the proliferating trade and investment barriers. See Pangestu, Rahardja, and Ing (2015) for a comprehensive review of

Indonesian trade policy over this fifty-year period; Marks and Rahardja (2012) for the most recent set of effective protection estimates; and Patunru and Rahardja (2015) on the possibility that Sadli's Law has lost its potency.

23. See Carney and Hamilton-Hart (2015) for an examination of the key business actors and their evolution during the democratic era. Borsuk and Chng (2014) provide a fascinating study of the dynamics of the Salim group, the most important Indonesian business conglomerate since the 1960s.
24. For analyses of the politics of post-Soeharto Indonesia, see for example Crouch (2010) and Aspinall, Mietzner, and Tomsa (2015). We also draw on the narrative developed in Aswicahyono, Bird, and Hill (2009).
25. See Lewis (2014) and several other chapters in Hill (2014) for an authoritative analysis of the achievements and challenges, and on which our analysis draws heavily.
26. See the papers in the special issue of *Asian Economic Policy Review* 11, no. 2 (2016) for the Indonesian record in comparative Asian context.

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