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CONTENTS

<i>List of Tables and Figures</i>	vii
<i>List of Contributors</i>	ix
<i>Acknowledgements</i>	xv
<i>Glossary</i>	xviii
1 Introduction <i>Rose H. McLeod and Andrew MacIntyre</i>	1
PART I FORMING AND REFORMING THE ARCHITECTURE OF GOVERNANCE	
2 Indonesia's Constitutional Change Reviewed <i>Andrew Ellis</i>	21
3 Electoral and Political Party Reform <i>Benjamin Reilly</i>	41
4 Tracing the Progress of Local Governments since Decentralisation <i>T Ketut Putra Erwani</i>	55
PART II THE ROLES OF GOVERNMENT	
5 The State and the Market in Democratic Indonesia <i>Ron Duncan and Rose H. McLeod</i>	73
6 Government and Private Business: Rents, Representation and Collective Action <i>Natalia Hamilton-Hart</i>	93
7 Muslim Politics in Indonesia's Democratisation: The Religious Majority and the Rights of Minorities in the Post-New Order Era	115

8	Children, Welfare and Protection: A New Policy Framework? Steven Beesel	138
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PART III THE INSTITUTIONS OF GOVERNMENT

9	The Civil Service: Towards Efficiency, Effectiveness and Honesty? Sajjan Singh	159
10	The Constitutional Court's Decision in the Dispute between the Supreme Court and the Judicial Commission: Barring Judicial Accountability? Simon Buzi	178

	<i>Index</i>	201
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LIST OF TABLES AND FIGURES

TABLES

4.1	Success of District Head in Introducing Innovations: Summary of Findings	68
5.1	Indicators of Legal System Inadequacies	83
5.2	Indicators of Bureaucratic Impediments to Business	83
7.1	Penal Sanctions in the Anti-pornography Bill	123
7.2	Sharia Bylaws in Selected Districts and Municipalities	128

FIGURES

5.1	Growth of GDP	74
5.2	The Soeharto Franchise	77

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5 THE STATE AND THE MARKET IN DEMOCRATIC INDONESIA

Ron Duncan and Ross H. McLeod

It must be remembered that there is nothing more difficult to plan, more doubtful of success, nor more dangerous to manage, than the creation of a new system. For the initiator has the enmity of all who would profit by the preservation of the old institutions and merely lukewarm defenders in those who would gain by the new ones. (Machiavelli, 1469-1527)

INTRODUCTION

Indonesia's economic performance has been significantly less impressive in the democratic (post-Soeharto) era than previously. The key indicator is the average annual rate of output growth, which not only reflects general improvements in living standards but is also by far the most important factor in reducing poverty. The rate of output growth over the three decades of the New Order regime (through 1997) was 7.4 per cent, but since the turn of the century (marking the start of the period of recovery from the economic crisis) it has been more than one-third lower, at 4.7 per cent (Figure 5.1). In terms of growth rates of per capita income, the decline has been even larger. From an economic point of view, it is this decline in economic performance that demands that we speak only of democracy's promise of good governance in Indonesia, it is a promise yet to be fulfilled.

We seek explanations for the decline in Indonesia's economic performance in the literature on new institutional economics. Writers in this field suggest that poor public sector governance, resulting in slow or no growth and development in many developing countries, is largely due to the lack of an appropriate set of the institutions critical to economic

Figure 5.1 Growth of GDP (% per annum)

Source: CEIC Asia Database.

growth and development—or to lack of enforcement of those institutions. In this literature, ‘institutions’ are defined broadly as constraints devised to provide a structure for political, economic and social interactions (North 1991). Since this rather abstract definition differs from everyday use of the term—note, in particular, that *institutions* are distinguished from *organizations*—we begin by elaborating North’s concept in more detail.

Institutions may be state or non-state, formal or informal. Non-state institutions are social institutions, values and norms. Formal institutions are constitutions, electoral systems, administrative systems, law and justice systems, and government rules and regulations. Traditional institutions such as customs may be seen as formal or informal, perhaps depending upon the degree of integration with other formal institutions such as constitutions and law and justice systems (Duncan 2003). According to North (1994), institutions are the underlying determinants of economic performance. In this analytical framework, it is natural, therefore, to focus on institutional change that has occurred in Indonesia since 1998. If we wish to explain the significant slowdown in economic growth.

According to Sir Winston Churchill: ‘It has been said that democracy is the worst form of government, except all those other forms that have been tried from time to time’. The post-Soeharto decline in Indonesia’s

that the institutional changes that constitute Indonesia’s recent democratisation are generally for the better? To put it more bluntly: was democratisation the right approach? Or was it a mistake to impose such a system on Indonesia at this stage of its development, simply because it has been highly successful in the West? Certainly, the changes allow wide participation in politics by citizens and their organisations, but what about the impact on economic performance? As noted at the outset, the record does not look good so far, eight years down the track.

Will matters eventually improve of their own accord? Not necessarily. While it is becoming more widely accepted that institutions determine the governmental and economic performance of an economy, it is also being recognised that inefficient institutions can be very difficult to change. In the terminology of the new institutional economics, the ‘transaction costs’ of moving to a more efficient institution will often be so high as to prevent the change; that is, the economy will remain in a ‘second-best’ world and, indeed, could be far from the optimum (Coase 1960; McCloskey 1998).

Although there has clearly been a decline in Indonesia’s economic performance in the post-Soeharto era, we should stress that it has not been a disastrous one. Indonesia is not about to implode; rather, it seems set to keep on muddling along, reducing poverty rather slowly. Our modest aim in this chapter is to redress the seeming imbalance of attention between political and economic institutional reform, and to make some suggestions for policy changes that would likely lead to better economic outcomes. Institutional change in the post-Soeharto era has focused primarily on facilitating the public’s participation in political processes; little of it has been directed to facilitating business activity, on which economic progress depends. There has been much talk but little action in this regard: at the time of writing, the business sector still awaited new legislation needed to create greater certainty in the fields of investment, taxation, mining, forestry and so on. In short, we suggest that the approach until now has been too narrow, and could be self-defeating in the long run if the balance is not redressed. It is not at all uncommon to hear of people pining for ‘the good old days under Soeharto’, when things seemed much more predictable.

A PUZZLE: EXPLAINING SOEHARTO’S SUCCESS

North (1990), Olson (1996), de Soto (2000) and others have stressed the overriding importance for the effective operation of a market economy of well-defined and secure private property rights, the impartial enforce-

part of civil servants. If individual rights to factors of production (especially land and capital) are ill-defined in legislation, and contracts made between parties to an economic exchange are not impartially enforced by the judicial system—that is, if property rights and contracts are not free from discriminatory intervention by politicians and bureaucrats—the costs of transactions and of production will make economic activity infeasible or highly suboptimal.

Yet both these requirements were lacking under Soeharto. Firms and individuals were highly vulnerable to extortion under the threat of violence by organised crime, thugs (*preman*), the military and the police. They were also victims of 'white collar' extortion by the bureaucracy. And justice was on sale to the highest bidder, so that people simply avoided using the courts as a means of resolving disputes. Thus it is something of a puzzle as to why the economy should grow so rapidly over such a long period in such circumstances.

Our explanation of this puzzle has two main parts. First, we note a very important point of North's argument: that the beliefs and institutions of a society do not necessarily evolve to provide a basis for economic growth. On the contrary:

most societies throughout history got 'stuck' in an institutional matrix that did not evolve into the impersonal exchange essential to capturing the productivity gains that came from the specialization and division of labor that have produced the Wealth of Nations (North 1994: 364).

We interpret this to imply that security of property and enforceability of contracts are much less important in the informal and traditional sectors of the economy, where there is little emphasis on finding new things to do, or new ways of doing things.¹ Rather, it is the modernising sectors of developing economies that generate the demand for institutional innovation, because of the increasing complexity and scale of economic activity in these sectors. Provided such demands are met, the economy will experience the kind of structural change that results in steady increases in productivity and incomes.

Second, we argue that the dynamic modern sector of Indonesia's economy did in fact benefit from security of property and enforceability of contracts—not by way of the formal legal system, but rather as a result of its symbiotic relationship with Soeharto, his ministers, key bureaucrats and the military. This relationship—the 'Soeharto franchise'—has been described in detail by McLeod (2005), and is illustrated in Figure 5.2.

Figure 5.2 The Soeharto Franchise

Like franchises in the world of business, the (unwritten) rules of the Soeharto franchise were designed to provide strong positive and negative incentives for its success. Key public sector officials could rapidly become wealthy if they lived by these rules, but if they did not abide by them or failed to perform well they would find themselves sidelined. The franchise prospered by means of 'private taxation', that is various forms of informal taxation of individuals and firms. The 'taxes' imposed by franchisees took two main forms: extortion of 'outsider' firms; and sharing of rents generated by the public sector through its economic policies and harvested by 'insider' firms—crosses of the regime (the 'cronies'), members of the first family and large foreign firms.² These

1. We hasten to add that in countries such as China and Vietnam, institutional

2. For example, a crony firm might be given a valuable concession to log natural

last three groups were the major beneficiaries of the system (aside from the franchisees themselves), since the rents generated for them in various ways by the franchise were shared with the latter, rather than being confiscated. And since the franchise depended on the profitability of these large, modern-sector, insider firms, it had every reason to ensure the security of their assets and to see that contracts to which they were party were enforced.

Treatment of 'outsider' firms and individuals by the franchise was exploitative or predatory, but to a controlled extent. It was in accordance with the 'stationary bandit' thesis developed by Olson (2000). The thesis argues that, unlike 'roving bandits', a stationary bandit—or a dictatorial regime—will have an interest in seeing the economy grow, so it is in the interest of the authoritarian regime to put in place institutions that will allow this to happen. Thus we argue that although the Soeharto franchise imposed net 'private taxes' on the outsider firms, it still provided sufficient in the way of the institutions needed for reasonably good economic performance, because it was in its own interest to do so.³ On occasion when elements of the franchise became too greedy, Soeharto stepped in to bring them back into line. For example, the notoriously corrupt customs service was replaced by a private international shipments surveillance company, SGS, for several years during the 1980s (Parker and Hutabarat 1996: 29), and there was a wave of extra-judicial killings—'mysterious shootings' (*petrus*)—of petty criminals and thugs at around the same time (Elsion 2001: 236–38).

In short, the success of the New Order regime in generating rapid and sustained economic growth over some three decades seems perfectly compatible with North's arguments about the importance of institutions for growth. The Soeharto franchise can be interpreted as a highly effective institution, or set of rules, guiding the behaviour of the entire public sector so as to ensure rapid economic growth, but without relying on a well-functioning formal legal system.

The authoritarian regimes of China and Vietnam have also experienced good economic growth by providing sufficient security of property rights and contract enforcement to give domestic and overseas businesses the confidence to invest. A point of optimism that can be drawn from the common experiences of Indonesia, China and Vietnam is that governance conditions do not have to be ideal in order for good economic growth to be achieved. These experiences reinforce the argument

that secure property rights and contract enforcement are the essential conditions or institutions for rapid growth, but they also confirm Grin-die's point about 'good enough governance'.

Among the governance reforms that 'must be done' to encourage development and reduce poverty, there is little guidance about what's essential and what's not, what should come first and what should follow, what can be achieved in the short term and what can only be achieved over the longer term, what is feasible and what is not. If more attention is given to sorting out these kinds of issues, the end point of the good governance imperative might be recast as 'good enough governance', that is, a condition of minimally acceptable government performance and civil society engagement that does not significantly hinder economic and political development and that permits poverty reduction initiatives to go forward (Gardale 2004: 526).

With these thoughts in mind, we hope that this chapter can make a useful contribution to the discussion of the priorities for the reform agenda in Indonesia.

EXPLAINING THE POST-SOEHARTO ECONOMIC DECLINE

The economic crisis that began to unfold in the latter half of 1997 was a godsend for those who had become disarmed with the extent to which Soeharto dominated Indonesia, and the all too obvious greed of his children, grandchildren and other family members. At first it was seen as an opportunity to push for the termination of a wide range of micro-economic policies whose main purpose was to enrich presidential cronies and the first family. But as the crisis deepened, it became apparent that it offered the possibility of achieving something that had previously become almost unthinkable: the removal of the president from office.

The implications of this were all too clear for the large domestic and foreign firms that had hitherto enjoyed the protection of the franchise. Security of property rights and enforcement of contracts could no longer be taken for granted, and the only obvious means of protection was to shift assets out of reach overseas. Of course it was impossible to shift physical assets such as factories and office buildings, but the same purpose was served by borrowing domestically and using the funds to purchase assets offshore. Such transactions were undertaken on a grand scale during late 1997 and early 1998, and the resulting capital outflow had the effect of amplifying greatly the magnitude of the initial shock to confidence of the sudden float of the Thai baht.

The actions of the central bank served only to make things much worse; it provided huge liquidity injections to the very banks whose owners were borrowing heavily in order to rearrange their global portfolios.

3. McLeod (2000) portrays this as an application of the Laffer curve concept, the idea that within the five authoritarian regimes there is a 'sweet spot' for

the last vestige of constraints on risky lending by the banks, by providing a blanket guarantee of their liabilities. In hindsight it is hardly surprising that the incipient crisis would be so badly mishandled, since under Soeharto there had never been any serious attempt to steadily upgrade the capacity (as distinct from the size) of the bureaucracy. Macroeconomic policy making had been reasonably competent over the previous three decades, but never more than that.

As the crisis deepened the Indonesian intelligentsia and the international community quite suddenly found themselves pushing, not for policy reform, but for Soeharto's departure. When in May 1998 he stepped down and was replaced by his protégé, Vice-President B.J. Habibie, there ensued a rush to redesign Indonesia's political architecture – in particular to dismantle the monopoly over the electoral mechanism that had allowed Soeharto to remain in office for so long.

In deference to the constitution, Habibie was permitted to take over the presidency, but not to serve out the remainder of Soeharto's five-year term. A new election was held as soon as it became practical to do so. A large number of political parties were permitted to compete for parliamentary representation against the hitherto dominant Golkar party and the only other two parties that had previously been allowed to compete in elections (but never to win). With Golkar's monopoly broken, its candidate, Habibie, was defeated. Before long further changes to the political architecture were introduced, motivated by the objective that Indonesia should never again be dominated by another Soeharto. Future presidents would be restricted to a maximum of two five-year terms; the military (on which Soeharto had relied for support) would no longer have a quota of seats in the People's Representative Council (DPR); and presidents would be elected directly by the people rather than indirectly by the People's Consultative Assembly (MPR). The power of future presidents was further diminished by the devolution of many of the functions of government to the local level, and by the fact that NGOs, organised labour and the media could no longer be repressed so heavily.

In this headlong rush to redesign Indonesia's political architecture, the reformers overlooked the crucially important fact that the Soeharto franchise they sought to destroy consisted not only of the president, Golkar, the parliament and the military, but also the bureaucracy, the judiciary and the state-owned enterprises. Reform of these key institutions seems to have been regarded at best as being of secondary importance. In effect, there seems to have been an assumption that with a freely and fairly elected president and legislature, these parts of the public sector would quickly be turned around and begin effectively to serve the interests of the general public. In other words, with democratisation Indonesia

would begin to enjoy 'government by the people, for the people', in Lincoln's famous words.

If there was such an assumption, it was badly mistaken, as we have noted, inefficient institutions can be very difficult to change. This is partly because the institutions adopted by a country tend to be determined by the predominant belief system – which itself may be misguided – and, more importantly in the present context, because existing institutions usually reflect existing political power relationships within a society. As North (1994: 360–1) puts it, 'institutions ... are created to serve the interests of those with the bargaining power to create new rules'. The bureaucracy, the judiciary and the state-owned enterprises were crucially important elements of the Soeharto franchise. By playing by its rules, high-level individuals within these institutions had benefited greatly. They could not be expected to acquiesce meekly in the face of reforms that would deprive them of these benefits.

What has been the consequence of this lopsided reform effort? For outsider firms, it appears that democratisation has had relatively little effect. These firms did not previously rely on the bureaucracy and the judiciary for property security or contract enforcement, and that remains the case. The collapse of the franchise has probably led to some increase in the level of extortion to which they are subject, since there is no longer any central control (Wilson 2006); indeed, businesses now have to contend with predation by newly independent and powerful bureaucracies at the local government level.

For insider firms, on the other hand, as we have already suggested, the demise of the franchise has meant that property is no longer secure and contracts are no longer enforceable. The first manifestation of this was the flight of capital offshore during the crisis, the ongoing manifestation is the reluctance of both domestic and foreign firms to repatriate this capital, and their reluctance to undertake new investment in Indonesia. This is hardly surprising, especially for foreign firms, since they can no longer rely on having well-connected joint venture partners to protect their interests. As a result, they are now extremely sensitive to the inadequacies of the legal system and to the predatory nature of the bureaucracy. Foreign portfolio investment has been running at high levels for some time, indicating that investors are willing to accept some (readily liquidated) financial exposure to Indonesia in their global portfolios, but investment in new capital stock remains at far lower levels (relative to GDP) than had become common before the crisis (Manning and Roesad 2006: 146). In short, new investment in the modernising sectors of the economy, on which structural change and economic growth depends, remains conspicuous by its absence.

WHAT NEEDS TO BE DONE?

The implication of the arguments presented above is that, to return to its previous trajectory of rapid growth, Indonesia will need to reform its formal legal system to provide security of property and enforcement of contracts, and thus restore incentives for investment in the modern sectors of the economy. The latest *Doing Business* report published by the World Bank and the International Finance Corporation again provides clear evidence of the inadequacies of the legal system (World Bank 2006). It ranks countries around the world in relation to various matters that affect the ease of doing business. Reflecting the weakness of its court system, Indonesia scores extremely poorly relative to the rest of the world with respect to such basic processes as enforcing a (standardised) contract (145 out of 155 countries) or closing a (standardised) business (116 out of 155 countries) (Table 5.1).

In relation to the difficulty of enforcing a contract, Indonesia's rankings for the time required to complete the process and for the overall cost are 134 and 151 respectively. Indeed, Indonesia is one of only nine countries for which the cost of enforcing a contract – at 126.5 per cent of the debt involved – actually exceeds the debt. The process takes no less than 570 days, that is, over 16 months. Small wonder, then, that those private sector entities that are willing to do business in Indonesia largely avoid using the courts for contract enforcement, relying instead on other means of protecting their interests, such as the use of private debt collectors, or simply being very careful in their choice of people to do business with.

The second subindex of interest here relates to the difficulty of closing a business. This measure focuses on bankruptcy law, and the main procedural and administrative bottlenecks in the bankruptcy process. Here we highlight the recovery rate and the time taken to complete this process. At just 13.1 per cent, Indonesia's recovery rate is far below the world average and less than that for every regional grouping – including Sub-Saharan Africa – resulting in a ranking of 119. In other words, only 36 countries perform worse on this measure. One of the main reasons that Indonesia's recovery rate is so poor is that the bankruptcy process takes far too long – some 5.5 years. Over such a long period, interest foregone on the amount of the unpaid debt becomes quite large, physical assets deteriorate, and there is the possibility that other assets are stolen or otherwise shifted beyond the reach of creditors.

We have no doubt that reform of the bureaucracy should also be given very high priority if Indonesia is to return to rapid economic growth. Again, the *Doing Business* report provides abundant evidence of the deleterious effect of the bureaucracy on private business activity (Table 5.2).

Table 5.1 Indicators of Legal System Inadequacies

Indicator	Measure	Rank (among 155 countries)
Enforcing a contract		
Time	570 days	145
Cost (% of debt)	126.5%	151
Closing a business		
Recovery rate (% of amount owed)	13.1%	116
Time	5.5 years	119
		133

Source: World Bank (2006).

Table 5.2 Indicators of Bureaucratic Impediments to Business

Indicator	Measure	Rank (among 155 countries)
Starting a business		
Time	151 days	144
		149
Hiring and firing workers		
Difficulty of hiring index (0–100)	61	120
Difficulty of firing index (0–100)	70	122
Firing costs (weeks of wages)	144.5 weeks	131
		130
Paying taxes		
Time	560 hours	115
		119
Registering property		
Cost (% of property value)	11.0%	107
		126
Dealing with licences		
Time	224 days	107
Cost (% of income per capita)	364.9%	98
		104

We begin by looking at the most important component of the starting a business subindex: the time taken to establish a (standardised) new business. In Indonesia this is 151 days. Entrepreneurs wanting to establish a business in the form of a legal entity are obliged to deal with slow-moving bureaucrats in the Department of Justice and Human Rights, the local municipality, the tax office, the Department of Industry, the Department of Manpower, the state-owned social security institution, the police and even the state printing company. In contrast, it is possible in a small number of countries to establish a business within the space of a week, and the average for the entire sample is just 56 days. The Indonesian figure is far higher than that in any of the regional groupings, and compares very poorly with the OECD figure of just 20 days. Indonesia ranks 149 out of 155 countries on this measure.

Another area where bureaucratic intervention makes doing business difficult is the labour market. The World Bank study focuses on several areas of labour market rigidity, and shows that Indonesia is far above average in relation to the difficulty of hiring and firing. Its rankings on these two measures are 122 and 131 respectively. But it is with respect to firing costs that Indonesia looks extremely bad by world standards; these amount to 144.8 weeks of wages, compared with only about 14 on average for all countries in the sample. Indonesia's rank on this measure is only five from the bottom, at 150.

In relation to the time cost of tax compliance, Indonesia again compares very unfavourably with other countries. The time allocated by a (standardised) company to tax compliance is far higher than the world average, and nearly three times as high as in the OECD countries; Indonesia's rank here is 119. A similar finding applies to the subindex for registering property. The cost of registering a (standardised) land and building package is as high as 11 per cent of the value of the property; on this measure Indonesia's rank is 126.

Licences are required for a vast array of purposes, and the Doing Business report attempts to allow for this by focusing on the bureaucratic procedures involved in building a (standardised) warehouse in each country. To obtain the necessary licence in Indonesia takes 224 days (that is, more than seven months); Indonesia ranks 98 in this regard. In terms of cost, equivalent to 364.9 per cent of per capita national income, it ranks 104.

The World Bank study is valuable in so far as it clearly documents the negative effect of the bureaucracy on private sector activity. The hard fact, however, will be to bring about reform. As noted earlier, the institutions adopted by a country tend to be determined by the predominant belief system, which is very difficult to change. They also reflect existing political power relationships, the resilience of which should not be underestimated.

So far as Indonesia's predominant belief system is concerned, we note that the evident belief in the desirability of free and fair competition within the electoral process is not matched by a corresponding belief in the desirability of competition in markets. This perhaps reflects a failure to differentiate the good and bad aspects of both the Dutch colonial system and the New Order regime when learning the lessons of history. It is not surprising that Indonesians who had to fight for independence from the Dutch would be inclined to reject capitalism, which tended to be equated with Dutch colonialism. Yet in important respects the nature of capitalism as implemented by the Dutch colonials departed markedly from its ideal form, since it was characterized by heavy restrictions on competition and by the significant curtailment of individual freedoms. Disenchantment with the Dutch system led the independence movement to place heavy emphasis on the development of cooperatives – an inferior form of business organisation that has never amounted to anything as important as its special billing in the constitution might suggest.

Likewise, disenchantment with New Order economic policies has helped create a bias against big business and in favour of small and medium-sized enterprises (with a continuation of lip service, at least, to cooperatives). There is also heavy distrust of market forces as the mechanism for deciding the allocation of productive resources among competing uses, reflected, within the bureaucracy, in an astonishing degree of faith in the ability of civil servants to make such decisions. An interesting example of the latter is the confidence with which the central bank is pushing its vision of the future for the banking system (Bank Indonesia 2004) – a vision that sees the disappearance of large numbers of small banks, despite the fact that these performed far better than the large banks during the crisis of the late 1990s (Fane and McLeod 2002: 289). There are, we are told, far too many banks in Indonesia, yet the only foundation for this argument appears to be the concern that more banks make more demands on limited supervisory resources. There is no evidence to support the assertion that the number of banks is in excess of the optimal level, and there is no reason that we can see why it should not be left to market forces to determine the structure of the banking system.

Resistance to institutional reform stemming from existing political power relationships can be seen in the recent surreptitious modification of the draft new investment law so as to prevent the loss of regulatory authority by the Investment Coordination Board (BKPM) (Manning and Roosaat 2006: 159). Another example is the success of the judiciary in preventing the Judicial Commission from playing an oversight role in relation to Supreme Court judges (see Chapter 10, this volume). The almost total lack of progress in relation to previous governments' commitments

state enterprises provides a third example of the capacity of another large remnant of the Soekarno franchise to stand in the way of reform.

The broad message of this chapter, therefore, is that the idea of *reformasi* needs to be thought of much more broadly, as more than mere democratisation. Soekarno did not control Indonesia so completely, merely by virtue of setting up a sham electoral system that guaranteed his repeated re-election. For the new democracy to work effectively a thorough overhaul of both the bureaucracy and the judiciary is essential. The details of this are beyond the scope of this chapter, but are discussed by Syntekstrom (Chapter 9, this volume). We note in passing, however, that there is a great deal to be gained from application of the fundamental idea that competition is beneficial – so readily accepted in the electoral sphere – to the area of personnel management in these two arms of government.

As for Indonesia's state-owned enterprises, which, for decades, have been used to enrich the strong and powerful at the expense of the general public, our recommendation is simple: they should be privatised, in order that their managers will have the strongest possible incentive to manage them efficiently.

We shall restrict ourselves in the remainder of this chapter to setting out what we see as the basic features of good economic policy, with a view to modifying the predominant belief system that underlies much of policy thinking in today's Indonesia.

WHAT SHOULD THE GOVERNMENT DO, AND WHAT SHOULD IT NOT DO?

Our point of departure is the observation that privately owned enterprises operating under free market conditions are the most efficient means of satisfying most demand for goods and services. In Indonesia, it needs to be recognised that the vast bulk of economic activity requires very little input from government. The key to designing sound economic policy is to identify circumstances in which the private sector either cannot operate, or requires complementary inputs from the public sector in order to do so effectively.

The most obvious case in which the private sector cannot operate is in the production of so-called 'public goods' desired by the community. Since this term is usually interpreted differently by economists and non-economists, let us be clear that what we mean by the term is services, consumption of which, once they have been produced, cannot be denied to anyone. It is this characteristic that makes production of public goods unattractive to the private sector – it is impossible to charge for their

let alone make a profit. Pure public goods are actually rather hard to find. The major examples are a country's system for providing national security and its system for providing domestic law and order. Citizens benefit from the services of protection provided by the armed forces and police (and courts and prisons), and they cannot be excluded from consuming these services.⁴ Another reason for largely ruling out private sector provision here is that the sector lacks the coercive power of the state.⁵ We make no comment on the adequacy or otherwise of Indonesian government spending on national security, but we have no doubt that far too few resources are devoted to the domestic system of law and order.

A second area in which public sector inputs are essential to complement private sector capabilities is in relation to the exploitation of natural resources. We take it to be self-evident that this process should be managed so as to maximise the benefits to the general public. It seems clear that this is the intention of article 33 of Indonesia's constitution (although the recently introduced natural resource revenue-sharing arrangements, which require a disproportionate share of the revenues generated from natural resources to be returned to the districts and provinces where they are located, would appear to conflict with this). As has been pointed out, this in no way requires that the government itself should undertake either exploration or exploitation work. All that is necessary is that it create the conditions in which private sector firms can compete among themselves for the right to do so. If bidding processes are fair, the government should be able to maximise the flow of resource revenues to itself for the benefit of the general public.

It is necessary, too, for the government to manage the environment: the atmosphere, waterways and seas. These have always been treated as free waste-disposal mechanisms, and the result has often been excessive pollution. Policy should not be directed to getting rid of pollution totally, since the costs of doing so would usually vastly exceed the benefits. What is needed is to arrive at the optimal trade-off such that, at the margin, the benefits of a further slight reduction in pollution is just offset by the cost of achieving this. In principle, we can get to this optimum by

4. Another pure public good is basic knowledge. The fact that it is not possible to establish intellectual property rights over basic knowledge implies that such research would be underprovided in the absence of government support for research in this area, but this kind of policy would seem to have relatively low priority in a country like Indonesia, with its relatively low educated population.

5. Mayling said that, not more than there is some scope for private sector participation, to give two examples, privately owned security companies are common in the United States, whereas elsewhere are almost unknown in the private sector.

forcing the polluter to compensate all other parties that are harmed by the pollution – in other words, by ‘internalising the externality’. In practice this is no simple matter, however.

A third area in which the private sector needs complementary inputs from the public sector is in the provision of infrastructure. Once again, the scope for the private sector to provide infrastructure on its own is very limited, because it lacks the coercive power of the state to acquire the land needed to support this infrastructure. The main examples are transport infrastructure (roads, railways, harbours, airports, bus and train stations); water infrastructure (dams, irrigation canals, drinking water treatment and distribution facilities, stormwater drainage, sewerage systems); electricity supply (power stations, transmission lines, distribution networks); telecommunications (fixed lines, satellites, radio transmission facilities); and gas pipelines (to transport gas from the field to industrial and population centres).

Many of these involve ‘natural monopolies’, providing a further rationale for government intervention.⁶ But there is considerable scope for ‘unbundling’ of the non-natural monopoly components, and for private ownership of both these and the core natural monopoly facilities. While only a single pipeline, grid or railway line may be needed, the water, gas or electricity pumped into the conduit does not need to be produced by a single supplier, nor does the distribution and sale of the service need to be in the hands of a monopolist. Activity at both ends of the conduit can be privatised to reap the benefits of competition. Moreover, while the medium of transport of these services remains a natural monopoly, access to the service by the competing producers and distributors can be regulated to ensure that the owner of the infrastructure does not take advantage of its monopoly status. Therefore, our broad policy recommendation is that ownership should generally reside with the private sector, and that the firms involved should be forced to compete to the fullest extent possible, or regulated in the case of natural monopolies. Thus we regard the decision by the Constitutional Court to nullify the Magsaysay government’s new electricity legislation – which was intended precisely to bring about greater private sector participation in the electricity industry – as particularly unfortunate.⁷

⁶ For example, only a single electricity grid, water or gas pipe, or railway line may be needed to provide the services, and duplication would result in higher unit costs.

⁷ In this regard, perhaps one of the most useful things the present government could do would be to push for an amendment to the wording of article 33 of the constitution to resolve the ambiguity of the term *business* (controlled by), by substituting an ‘unrestricted’ interpretation and meaning, as in the case of

Another area that cannot be handled by the private sector is income redistribution. Indeed, when the private sector becomes involved in this, it is called theft! Only the state has the right to tax citizens in order to make transfers (in cash or in kind) to others. Economics has nothing to say about the extent to which this should be done: this is a value judgement made by society through the political process. But economics does have something to say about the impact of redistribution activity on the performance of the economy. Redistribution can weaken incentives to work hard and take risks, and may give rise to wastage of resources as the losers try to find ways to avoid being taxed and the gainers try to find ways to increase the handouts they receive.⁸ Our general recommendation, therefore, is that redistribution should be kept reasonably limited, and that it should be carefully targeted. Redistribution implemented by providing particular kinds of services offers some advantages. For example, free or highly subsidised education and health care can be targeted fairly carefully to low-income families. As in the case of infrastructure, we again argue here for mechanisms that minimise direct government involvement, such as the issuance to target groups of health care cards and education vouchers that can be ‘spent’ at private sector providers.

We have already argued for the privatisation of existing state enterprises. The objective is not to obtain additional revenue for the budget, but rather to increase the efficiency of resource use in the economy. The managers of state enterprises do not have their own funds at risk, and the owners – the general public – are much too far removed from management to be able to exercise any meaningful supervision or control. Private sector owners whose wealth rises and falls with their firms’ profits and losses have far stronger incentives to manage enterprises effectively. State enterprises in Indonesia collectively have a long and sorry history either of making losses or of frittering away the value of natural resources (such as oil) under their control. Nothing has changed in this respect with the advent of democratisation. The incessant scandals surrounding Bank Mandiri (see Firdausy 2006) clearly illustrate the folly of turning away from previous governments’ commitments to privatise the state banks.

For the same kinds of reasons, government bureaucrats should avoid introducing policies that amount to selling private sector owners how to manage their enterprises. The fact that the owners have their own wealth at risk implies that they are much more likely to make sound management decisions. Just as it is unfair to the general public when governments step in to bail out failed private enterprises, so is it unfair

to businessmen owners when governments step in to force decisions on them without having to bear responsibility for the consequences if their decisions turn out to be unwise. And this is highly likely, only a minuscule proportion of Indonesian civil servants have any personal experience in managing profit-oriented enterprises in the private sector. In short, we believe that the government has little if any role to play in deciding how much should be invested in any particular part of the economy.

Finally, we argue that the government should avoid all forms of intervention that have the effect of favouring one firm over its competitors, one industry over other industries, or one sector over the rest of the economy. There are far more important things for the government to do than waste its limited skill resources in trying to pick winners. In reality, when governments operate in this manner, they are more likely to be doing so in return for some kind of pay-off from the beneficiaries of such distortions, than in response to a genuine expectation that there will be a benefit to the public as a whole. Indeed, we would be very happy to see the abolition, or at least a significant scaling down, of government departments such as industry and agriculture, most of whose activity does nothing more than favour particular firms, industries or sectors at the expense of others and at the expense of either taxpayers or the general public as consumers.

SUMMARY

The performance of the Indonesian economy has declined significantly in the post-Soeharto period. We argue that this is a result of the reform program giving priority to ensuring improved public participation in electoral and parliamentary processes, while ignoring the need to ensure that the modern business sector can operate in an effective manner within a democratic environment. We take on board ideas from the new institutional economics to argue that the good economic performance of the Soeharto regime was due to the fact that the regime ensured security of property rights and contract enforcement for favoured businesses. With the collapse of the regime, these institutions, which are fundamental to the operation of the private sector, also collapsed. Establishing new institutions in their place that can operate effectively in the new democratic environment has not been a priority of the reform program.

We argue that improved economic performance will require fundamental reorganisation of the underperforming judicial and bureaucratic systems and the state-owned enterprises. However, we recognise that there will be considerable resistance from vested interests in the existing institutions on their reforms will and the reform clock should not be stopped.

considerable effort to develop better public understanding of the appropriate role of the government in generating healthy, productive economic sectors.

In the interest of overcoming the widespread, fallacious beliefs about the role of government, we have provided a framework for understanding what it is that the government should do and what it should not do. Generally, the government's role should be to undertake activities that the private sector cannot undertake, or can undertake effectively only with complementary action from the public sector.

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6 GOVERNMENT AND PRIVATE BUSINESS: RENTS, REPRESENTATION AND COLLECTIVE ACTION

Natalia Hamilton-Hart

CHANGE AND CONTINUITY IN BUSINESS-GOVERNMENT RELATIONS

An apparent paradox of the business-government relationship in Indonesia is that although business players are often powerful, the collective interests of the business sector are frequently neglected. Is business too influential, or not influential enough? Some voices from the business sector claim that they are at best ignored by the government, and all too commonly preyed upon, subject to burdensome regulation and exposed to illegal extortion by state actors. Yet the government continues to confer privileges on many business people, both in the guise of legally mandated benefits and in the form of informal forbearance and illegal collusion. These privileges almost always come at the expense of public welfare, generating economic inefficiencies and often direct costs to the taxpayer.

The basic features of this skewed relationship date back to the 1950s, and to some extent endure simply because of their self-reinforcing character. But to say that things are bad now because they have been bad for a long time does not capture the underlying conditions that led to this situation, or allow us to identify possible avenues for change. This chapter explores the extent of change in the business-government relationship in recent years. It asks why some legacies from the past have persisted and whether there are other reasons why business-government relations in Indonesia are frequently associated with sub-