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ECONOMIC REFORMS IN INDONESIA AFTER THE 1997/98 ECONOMIC CRISIS

HADI SOESASTRO, HARYO ASWICAHYONO AND
DIONISIUS A. NARJOKO

CENTRE FOR STRATEGIC AND INTERNATIONAL STUDIES, JAKARTA

CSIS@CSIS.OR.ID

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Economic Reforms in Indonesia after the 1997/98 Economic Crisis

Hadi Soesastro, Haryo Aswicahyono, and Dionisius A. Narjoko¹
CSIS, Indonesia

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Abstract: This paper reviews the experience of undertaking reforms in Indonesia after the economic crisis 1997/98, focusing on the reforms made under the last two presidents: Megawati and Susilo Bambang Yudhoyono. The review leads the paper to draw some lessons from the experience. Among other, the role of IMF in disciplining the policy direction, and hence the reforms, is quite evident. This is in the light of dramatic change in the political economy of decision-making process after the crisis, where the power was shifted from the president to the government. The paper also finds that one important constraint for delivering a successful reform is nationalistic ideology which strongly opposes the mechanism for moving towards more efficient market. Meanwhile, in practical terms, the change in political architecture seems to have contributed to the coordination problems across the governmental agencies and ministries, which leads to slow progress in the policy implementation.

1. Introduction

The so-called IMF-supported programs for Indonesia began with the signing of the first letter of intent (LOI) at the end of October 1997 and extended over a six year period until the termination of the last one at the end of December 2003. During this period four different governments were implementing the reform programs with varying successes. Three factors have influenced the outcome: IMF conditionality, ownership of the program, and capacity to implement.²

Under President Soeharto difficulties in implementing the program were apparent from the outset. The President was unhappy with the immediate step taken under the program

¹ The authors are grateful for excellent research assistantship provided by Carlos Mangunsong, CSIS, Indonesia.

² Boediono (2002).

to close 16 banks, which included a bank that was owned by one of his sons. He also appeared to have rapidly lost confidence in the program as the country's economic conditions continued to worsen. He began to seek advice from groups other than his economic team and toyed with alternative ideas, such as the Currency Board System, to replace the IMF program. It has also been pointed out that the inclusion of a structural reform agenda in the program, rather than limiting it to macroeconomic stabilization and improving the health of the financial system, could have been the main reason why the program ran into great difficulties.³ The conditionality included the dismantling of the clove monopoly and the withdrawal of governmental support for the national aircraft industry, IPTN, and for the Timor national car projects, all involving people who were very close to President Soeharto. These measures were not urgent to overcoming the crisis, but they were included because improving governance was seen as important to restoring public and market confidence in the government. The implementation of the program was characterized by rapidly weakening ownership. Poor implementation was not due to the capacity of the bureaucracy that, with all its shortcomings, was still functioning.⁴

In May 1998 Soeharto handed the presidency to Habibie. In July a new IMF-supported program was agreed upon. This second agreement contained a strategy for corporate restructuring and a more elaborate bank restructuring program.⁵ For the next year, six successful reviews of the program took place. The success was due to a number of factors, namely: the program was clearly spelled out; there was singleness of purpose at the top; the agreed basic strategy was insulated from the pull and push of sectional interests; rapid communication and candid interaction between the president and the economic team; bureaucratic reform; and workable relations between the government and

³ Soesastro and Basri (1998).

⁴ Boediono (2002) made this observation based on his personal involvement in the process as a Director at Bank Indonesia and later as Head of the Indonesian Planning Agency, BAPPENAS.

⁵ During the six years there were three agreements with the IMF. The first was signed on 31 October 1997, the second on 29 July 1998, and the third on 20 January 2000. Each agreement stipulates a program that is contained in the Memorandum of Economic and Financial Policies (MEFP). Following each review a "supplementary" MEFP was signed to continue the program. The more substantial change in the program would produce a "strengthened" MEFP or "extended" MEFP. In total there were 23 such MEFPs. Two reviews have led to a suspension of the program, one towards the end of the Habibie government and the other one towards the end of the Wahid government.

the parliament and the regions (following the adoption of regional autonomy).⁶ Unfortunately, the Habibie government became entangled in a serious scandal of political financing (the Bank Bali scandal) to help win his election as president. The government's refusal to publicize the audit on Bank Bali, as demanded by the IMF, led to a standoff that resulted in the suspension of the program in September 1999.

The IMF-supported program was critical for the maintenance of a coherent economic agenda during a period of continued turmoil and tumultuous changes of government. An important aspect of the program was the measures taken to strengthen institutional development to promote greater transparency and competition, more institutional autonomy, and a stronger legal and regulatory environment. Amongst the earlier measures were the reforms to overhaul the bankruptcy system and the establishment of a commercial court. Another major initiative was the introduction of competition policy and the enactment of the Law regarding Prohibition of Monopoly Practices and Unhealthy Competition (Competition Law) in March 1999.⁷ The independence of Bank Indonesia was established under the Central Bank Law of 1999.

Abdurrahman Wahid was elected president in October 1999. A new, and third, agreement with the IMF was signed in January 2000 and extended the program to December 2002. This new program incorporated a medium-term agenda that had four components: a medium-term macroeconomic framework; restructuring policies; rebuilding economic institutions; and improving natural resources management. The macroeconomic framework outlined a recovery program while maintaining price stability. The implementation of the program was extremely slow. Wahid reshuffled his cabinet several times but that did not help. He also established the National Economic Council (DEN) and the National Council for Business Development (DPUN), but their main task was to give him a "second opinion." Soon enough Wahid was also implicated in a number of governance problems, including the Bulog scandal that eventually led to his removal from office.

⁶ Boediono (2002).

⁷ A Commission for Business Supervision (KPPU) was set up in 2000.

IMF loan disbursements were delayed because of the scandals and the poor implementation of the program by the economic team, which was essentially opposed to the involvement of the IMF. During Wahid's government there were only three supplementary MEFPs, and the last one was suspended in December 2000. Two main problems were faced by the Wahid government in implementing the reform program.⁸ First, the program contained a long list of issues related to structural conditionality. Second, implementation capacity declined because of the following reasons. There was no team work amongst the economic ministers and there was a growing rift between the government and the central bank, Bank Indonesia, which had recently gained its independence. The bureaucracy was sliding into a state of paralysis because of uncertainty about the direction of the reform process. Decentralization (regional autonomy) caused further complications, and the relationship between the government and the parliament continued to worsen.

President Wahid failed to exercise economic leadership, and with a weak economic team in the cabinet, it was the executing agencies that held the key to the implementation of policies to revive the economy. In overcoming the crisis, the previous government had established new institutions, which included the Indonesian Banking Restructuring Agency (IBRA), the Indonesian Debt Restructuring Agency (INDRA), and the Jakarta Initiative Task Force (JITF). Together with Bank Indonesia, the Ministry of Finance, the State Minister for Investment and State Enterprises, all those "crisis institutions" were involved in the gigantic task of credit restructuring, which was one of the most important tasks towards economic recovery. Coordination amongst these institutions and agencies was very weak and of an *ad hoc* nature.

By the middle of 2001 relations between the president and the parliament became very tense. In July Wahid was removed from office and was replaced by his Vice President, Megawati. Megawati's economic team moved swiftly to mend the relations with the IMF. In August the government produced an "extended" MEFP, which was built upon the third

⁸ Boediono (2002).

agreement (of January 2000), as the basis for renewed IMF support that was already suspended for eight months. In December another “extended” MEFP was issued with the request to the IMF to extend the program to December 2003. Over the next two years six “supplementary” MEFPs were issued. Although Megawati’s economic team was supportive of and became more pro-active in implementing the IMF programs, the process was slow and difficult due to problems of implementation capacity that had already begun to emerge under the Wahid government. Political stability was restored under Megawati because her style of leadership was based on the wisdom of not rocking the boat. She was also given the assurance by the Chairman of the People’s Consultative Assembly (MPR), the highest state body electing the president, that she would not be removed from office before the 2004 presidential election.

From the middle of 2002 there were increased calls for the government to terminate the program with the IMF when it ended at the end of 2003. By then Indonesia was the only remaining country under the IMF from the 1997/98 Asian financial crisis. The general session of the MPR in August 2002 formally recommended the development of a framework for ending Indonesia’s dependence on the IMF. This opened the debate on the form of engagement with the IMF after the program expired (“exit strategy”). In May 2003, the IMF outlined three broad options for Indonesia: (a) a Standby Arrangement, amounting to a continuation of the program; (b) a Precautionary Standby Arrangement; and (c) exiting the standby framework completely but engaging in a “post program monitoring.” Under all of these scenarios Indonesia would paid off its debt to the IMF, amounting to US\$ 9.2 billion, over a period of seven years. A fourth option was proposed by those that demanded a total break from the IMF, suggesting that Indonesia could repay the entire outstanding debt to the IMF using the country’s international reserves.

In late July 2003 the government announced that it would not extend the IMF program. It formed an interagency team to formulate an exit strategy taking into consideration issues of “financing gap” and “credibility gap” when ending the IMF support. The former refers to the increased financing needs of the government, and the latter refers to the possible adverse impact on market sentiments. The decision to end the IMF program was

influenced by the approaching election year, to some extent in response to the growing nationalist mood in politics and public discourse. In addition, the government felt that Indonesia's improved macroeconomic condition was sufficiently favorable to ending the program.⁹ On 10 December 2003 the government signed the last LOI which led to the release of the final tranche of the third agreement with the IMF.

In preparation for the ending of the IMF-supported program, on 15 September 2003 the government issued an Economic Policy Package Pre and Post-IMF, known as the White Paper. It contained Indonesia's own economic recovery program for the rest of 2003 and 2004. The objectives of the White Paper were: (a) to sustain and build on the macroeconomic stability that had been achieved; (b) to continue the restructuring and reforming of the financial sector; and (c) to increase investment, exports and employment (see Box 1). The policy package was in general well received by the public and the market. The part of the package that raised some skepticism was the section that addressed the issues of investment, exports and employment because it lacked vision, coherence, and credible policy measures. On the whole, the significance of the policy package was to help lock-in government reform policies, especially in an election year.¹⁰

The White Paper was quite wide-ranging, and in the assessment of many observers it was much more elaborate and ambitious than the LOIs produced under the IMF-supported programs. The policy package, however, was produced entirely by the Indonesian government with inputs from the private sector and in consultation with a group of independent economists. There was a greater sense of ownership that promised to produce stronger commitments for its implementation. It also was instrumental to improving coordination and cooperation between the Ministry of Finance and Bank Indonesia.

⁹ MacIntyre and Resosudarmo (2003).

¹⁰ Soesastro (2004).

Box 1

Economic Policy Package Pre and Post IMF

On 15 September 2003, the government issued Presidential Instruction No 5/2003 on the 'Economic Policy Package in Conjunction with the Completion of the Government's Program with the IMF'.

The main elements of this Policy Package were as follows:

Maintaining macroeconomic stability

The Target is to achieve a healthy and sustainable fiscal position and to reduce the rate of inflation while maintaining sufficient international reserves for medium term needs. The fiscal policy to achieve that target includes the following: (a) to reduce the budget deficit gradually to achieve a balanced position over the period 2005-2006; (b) to reduce the stock of government debt to GDP to a safe position; (c) to reform and modernize the national tax system to create reliable revenue source; (d) to increase the efficiency of government expenditures; and (e) to develop an effective debt management system.

Restructuring and reforming the financial sector

In view of the strategic role of the financial sector in stabilizing the economy and promoting recovery, the policy measures will be focused on: (a) establishing a Financial Safety Net through the development of a Deposit Insurance Corporation, establishing a Lender of Last Resort facility at Bank Indonesia, and strengthening the financial system with the establishment of a Financial Services Authority; (b) continuing with the program of restructuring and improving the health of the banking sector, state owned, banks under IBRA (Indonesian Banking Restructuring Agency) and others; (c) tightening the oversight of money laundering; (d) improving the performance of capital markets and their supervision; (e) consolidating the insurance and pension industries; (f) improving the performance and governance of state-owned enterprises; and (g) advancing the development of public accounting.

Increasing investment, exports and employment

It is recognized that the private sector plays an important part here and that the main task of the government is to create a climate conducive to the private sector through good policies and institutions. The key policy initiatives include: (a) improving investment policy and trade through One-Roof Service, and a National Investment and Export Team to assess inter-sectoral problems; (b) increasing legal certainty by revising the Bankruptcy Law, and bringing regional regulations into line with higher regulations or the public good; (c) building and rehabilitating infrastructure to assure services in electricity, transportation, telecommunications, and water resources; (d) increasing the transparency of public services; and (e) improving equity through programs to eradicate poverty and job creation.

The Megawati government was rather successful in building and maintaining macroeconomic stability thanks to the development of institutions, ensuring the independence of Bank Indonesia in conducting monetary policy, as well as the

reorganization of the Ministry of Finance (under the 2003 law on government finance) to ensure fiscal prudence.

With the ending of the IMF-supported program, Indonesia agreed to a Post Program Monitoring, called Post Program Dialogue, with the IMF.¹¹ This involves two monitoring visits a year by an IMF team to review progress towards achieving the set of reforms and targets formulated by Indonesia, as articulated in the White Paper for 2004. This is in addition to two other IMF staff visits a year, one of which is the regular Article IV consultation. The consortium of donors, CGI (Consultative Group on Indonesia), also acts as a kind of watchdog. In late 2003 it set up a CGI Working Group on Investment to focus on measures to improve Indonesia's investment climate.

Of significance were the emerging home-grown efforts to monitor the implementation of the reform programs. The Indonesian Chamber of Commerce (Kadin Indonesia) established an independent monitoring team. It invited the participation of the Jakarta Japan Club Foundation (the organization of Japanese investors in Indonesia), Amcham Indonesia (the American Chamber of Commerce in Indonesia), the International Business Chamber, and a number of independent economists. In the first Press Statement of November 2003 the independent monitoring team laid down key policy areas that were given highest priority by the private sector. These included improving the investment climate and the overall business climate, to which legal reform was seen as critical, reform of the tax administration, reform of customs administration, careful drafting of implementing regulations of a new Manpower Law, and various measures to improve infrastructure (energy, electricity, telecommunications and transportation).

The "monitoring" team became a misnomer as the team decided on a mode of operation that did not monitor progress on the implementation of the program and issue regular monitoring reports. Instead it offered to work with the government to assist in the successful implementation of the programs by working directly with the respective

¹¹ Post Program Monitoring by the IMF ended in October 2006 with the full repayment of the IMF loans by the government (Bank Indonesia), about 3 years ahead of the original schedule.

government agencies by providing inputs in the formulation of regulations and policy measures. The team established several subgroups, such as on taxation, customs, investment, and labor, that interact with their government counterparts. It was the government itself that produced regular reports on the progress of implementing the White Paper. However, it was difficult for the public to assess whether the issuance of regulations and reform policies was indeed translated into actions and changes on the ground. Overall it can be concluded that the government was successful in maintaining macroeconomic stability. Improvements in the financial sector had mixed results. Credit growth remained sluggish, but this could partly be explained by the continued difficulties in the real sector and failure to improve the investment climate. In 2004 much of the attention was diverted to the April general elections and the two rounds of direct presidential elections.

Kadin Indonesia, on the basis of the “monitoring” exercises, sought to produce a set of recommendations that it could present to the elected president. It set up a task force to draft the recommendation. An early version was presented to President-elect Susilo Bambang Yudhoyono, but the final report, “Revitalization of the Industry and Investment” was formally submitted in October 2004 to the new President.

In forming his cabinet, President SBY chose a businessman, Aburizal Bakrie, who was also the immediate past Chair of Kadin Indonesia, to be the Coordinating Minister for Economic Affairs. It is not clear whether this decision had been influenced by Kadin’s high profile and its recommendations. Kadin members argued that having a business person at the helm of Indonesia’s economic management would finally deliver results. In any case, it appears that many of Kadin’s recommendations were adopted by the SBY government.

One of the first initiatives of the new government was to convene an Infrastructure Summit in January 2005 to attract the participation of the private sector, domestic but with an eye on foreign investors in particular, in the development of infrastructure. The result was disappointing as the government failed to deliver on many of the reforms and

regulations that would be necessary to improve the climate for infrastructure investment.¹² The decision in December 2004 by the Constitutional Court to annul the new Electricity Law that open up the industry was also a major set-back. Investors continued to adopt a wait and see attitude.

In November 2005 the president undertook a mini reshuffle and replaced Aburizal Bakrie with an experienced and highly regarded technocrat, Boediono. As Minister of Finance under Megawati, Boediono was responsible for strengthening the country's macroeconomic conditions by adopting relatively conservative policies for which he is well known. In his new position he soon found out that he needed to look beyond maintaining macroeconomic stability to tackle the urgent and more complicated issues of investment and employment.

In February 2006, the government issued a policy reform package to improve the investment climate. This reform package “signaled an increased sense of urgency about the government's reform agenda, and a new, more systematic approach to reform by Boediono In contrast to the ‘deal making’ or ‘CEO’ approach taken by his predecessor.... .”¹³ It was a rather substantial package as it involves a total of 85 items for action. This included several major pieces of legislation, a new capital investment law and a new tax law, an amendment to customs and excise law and revisions to the manpower law. Following major demonstrations by labor unions, the government has put the revision of the manpower law on hold, but it has submitted the other draft laws to the parliament. The process is not likely to be a smooth one given political sensitivity of the issues, increased nationalistic sentiments (capital investment law), vested interests (taxation law), and maneuvering by political factions in the parliament with various political agendas. Several criticisms have been directed towards President SBY for not using his political capital and strong legitimacy (having 62% of the popular votes) in dealing with the parliament to ensure that reasonable compromises can be achieved with a reasonably short time (Wanandi, forthcoming). Pressures are building up as

¹² Soesastro and Atje (2005).

¹³ Manning and Roesad (2006).

unemployment continues to grow and incidence of poverty also increases. President SBY's leadership is certainly not the only factor, but perhaps an important factor, in explaining why reforms continue to be slow.

The following sections will review in greater detail the experiences of undertaking reform during the Megawati government and the challenges faced by the SBY government in undertaking further reforms that will largely have to deal with a host of microeconomic problems, in addition to legal reform and the fight against corruption. Disciplining policy may not be the main problem now, granted that Boediono, being at the helm of economic management, is fully backed by the president. The absence of IMF, which has played an important role in disciplining policy, will not be critical. What may be missing could be the strong drivers for the reform. Some international and regional commitments could help, but perhaps the major impediment to sustaining reform is weak implementation capacity and mechanisms to assure that policy decisions get acted on by the bureaucracy and other governmental agencies at the national and regional levels.

2. Economic and policy reforms over the 2001 – 06 period: a review

2.1 Megawati administration period¹⁴

To organise the review, this section divides the reforms into two groups: the IMF related and non-related reforms. The former includes the amendment of central bank Law (No. 23/1999) and few reforms to meet the structural benchmark of the IMF-LOIs signed during the Megawati period. The latter includes few reforms undertaken either to improve the earlier administrations (i.e. Habibie's and Abdurahman Wahid's) and/or to achieve the objective of the White Paper.

2.1.1 The IMF-related economic reforms

There were nine IMF-LOIs signed by the government, including the one that marked the end of IMF program. The LOIs covered the following key areas: overall macroeconomic

¹⁴ Owing to space limitation, this paper reviews only several major reforms undertaken in the period.

policy objective; fiscal decentralization; banking restructuring; privatisation; legal reforms; and reforms in public and other important sectors in the economy. Unlike the earlier ones, in these LOIs the IMF seems to have changed its approach, from micro to broader macro policy guidelines (Siregar 2001). As reported in Athukorala (2002, p.142), the change was attributed both to the improving confidence of the Megawati's administration and the 'learning-by-doing of the IMF in dealing with the economic crisis in Indonesia.

The performance of the government in delivering economic reforms to meet the structural objectives outlined in the LOIs had been mixed. On the one hand, the government, for example, was successful in having the central bank law amended and the state finance law passed. On the other, the government was not so successful in reforming the tax administration and privatisation.

The amendment of the central bank law (No. 23/1999).

The amendment of the central bank law in principle aimed at addressing the weaknesses of the law, which, as noted by Goeltom and Pangestu (2001) and McLeod (2003), including the following main issues:

- Unclear definition on the mechanism to achieve the central bank's (Bank of Indonesia's – BI's) single objective, namely stabilising the Rupiah exchange rate. This is the issue of BI's policy instruments. In the law, the term 'stability' could be interpreted to mean either stability of the domestic price level, or stability of the exchange rate. In theory, it is clear that monetary policy cannot achieve both simultaneously.
- Confusing interpretation regarding the BI's goal of independence. On the one hand, the law gives an authority to BI to determine the level of the objective (i.e., the target inflation rate each year), but on the other, the law also requires BI to take into account the likely impact of its monetary policy on the overall national economic performance in achieving its objective.
- The law is lacking an effective mechanism to monitor, or to account for, the performance of the BI's senior managers.

After a long process in the parliament, the amendment of the law was finally passed by the parliament on 19 December 2003. While addressing the issue of BI's independence, the amendment kept the provision on the BI's instruments. Concerning the BI's goal of independence, the amendment contains a clause that, in principle, reduces the extent of BI's independence. In the amendment, the inflation target is to be determined jointly by the government and BI. While this provision follows the modern model of central banks, as in Australia and New Zealand for example, to date it is not clear how it would play out. This, obviously, creates a room for conflict between BI and the government agency, most likely the Ministry of Finance (MOF). The amendment also established a supervisory board, comprising five members, to improve the accountability for the performance of the BI's senior managers. The board, however, is only concerned with the BI's internal operation.¹⁵

While the amendment (i.e., the reform) was successfully delivered, it is important here to note the difficult process in delivering the amendment. The amendment proposal was strongly scrutinised by the parliament, and at one point, the proposal reached about 400 amendments (Goeltom and Pangestu 2001). The main reason for this difficult process, also being the main objection from the IMF, was the fact that these amendments could potentially undermine the autonomy of BI. The deadlock arising from the persistence of the two sides (i.e., the government-and-IMF and the parliament) led to the forming of a 'neutral' panel of experts to provide some policy recommendations. While the exact recommendations were unknown, it seems that the points in the amendments outlined above were the key recommendations given by the panel.

Reforming the public finance

The reform to improve a sound system of public finance management and good governance was marked by the passing of the state finance law (No. 17/2003) in the early second half of 2003. The law had been in the parliament's deliberation process for quite a long period of time, since it was one of the three public finance laws first proposed in

¹⁵ The members of this board would be appointed by the president, subject to approval by the parliament.

2000.

The state finance law was an important milestone in the public finance reform. It was designed primarily to address the increasingly ineffective law governing the state finance management (Ginting 2003). For about sixty years since its independence, Indonesia had relied on the colonial-era legislation on government budgetary management. In addition to not putting accountability on government expenditure, the old law clearly was not able to cope with the changes in institutional and financial arrangements taking place since independence. This particularly concerned the new arrangements for regional autonomy initiated in early 2001.

To ensure the accountability for public finance management, the state finance law puts great emphasis on the auditing process, which is now designed to be no longer a formality, and mechanisms to promote greater transparency in the state budgeting process (see Box 2). The state treasury law, aimed at providing the details for the implementation of state finance law, was also passed by the parliament a few months after the passing of the state finance law. In addition to these, the state finance law also ensures a mechanism to govern fiscal discipline, both at the level of central and regional government.

As argued by Ginting (2003, p.356), the success of the state finance law depends on the capacity to implement the law effectively. This is because the law dramatically breaks the 'long-established' system which had been followed by the government. In this respect, a successful implementation would require a bureaucratic reform that could change the quality of civil service. As is commonly known, the promotion of civil servants tends not to be based on performance. A successful implementation would also require an ability to transfer the power from the MOF, which under the old system played a significant role in determining the allocation of state funds, to the line of other ministries. While clear as a concept, implementing this in practice would not be easy, because – combined with the poor quality of civil service in general – it means the bureaucrats have to withdraw their power to impose informal taxes under the old system. Ensuring a smooth process in the power transfer therefore would also require a significant bureaucratic reform.

Box 2.**The main articles of the state finance law (No. 17/2003).**

The primary objective of the law is to ensure that public finances are managed in efficient, effective, transparent and accountable manner. To ensure this, the law stipulates the following:

- All public funds must be managed in accordance to the law. To ensure this, the law provides a comprehensive definition of the role and scope of public finance. This instruction partly aims to eliminate the off-budget financing which is often regarded as one sources of corruption.
- The Supreme Audit Agency (*Badan Pemeriksa Keuangan – BPK*) must audit every transaction related to state finance. As noted in the text, this shift the common practice that audit process would no longer a formality.
- Budget execution has to be done in clear and transparent manner. The law clarifies the allocation of the responsibility of state finance within the executive, that is, the finance minister plays a role of chief financial officer with the each line of minister plays a role of chief operation officer. The law requires an establishment of a more effective and transparent treasury management, which was governed by the state treasury law passed.
- Related to the earlier point, the law stipulates a clear budgetary process within the executive and legislative branches of the government, both at the national and regional level.
- The fiscal relationship between the central and regional government, central government and central bank, and regional government and foreign government/financial institutions. The law leaves the authority for managing foreign grants and loans to central government, which can pass the funds to regional governments. In this context, the law also put discipline criteria to ensure fiscal sustainability, in which the law requires that the size of government deficit and the ratio of government debt to GDP may not exceed 3 and 60 per cent, respectively. This criterion applies to both central and regional government.
- The government to provide comprehensive information at all steps of budgetary process, including performance indicators for each budget item in addition to the financial information itself.

Source: Ginting (2003, p.354-56).

Tax administrative reform

Reforming tax administration was one of the structural reforms included in the LOIs. The reform has the main objective of increasing tax revenue collection through the implementation of some ambitious structural measures. The reform included measures to establish a special unit to pursue large taxpayers and to create a more efficient and effective tax system. To appreciate the ambition of these measures, it is important to put them in the context of the economic situation at that time. That is, the tax administration reforms, together with some other fiscal measures, were intended to increase the flexibility of fiscal policy in promoting economic recovery from the economic crisis. As noted by many economists, fiscal policy was very limited at that time due to the sharply rising public debt as a result of the crisis.

The government established the Large Taxpayer Office (LTO) in early 2003. Despite the promising start and objective, which was to improve tax administration through faster processing with increased transparency, there was no significant progress or follow-up regarding the establishment of the office.

The government also completed and submitted the draft for amendment of the general tax procedure law (No. 16/2000) in December 2003. The draft was quite controversial. Among other things, the draft gives the tax department full authority to investigate a tax crime without consultation with police and includes a provision for sizeable fines for lesser violations, such as late or failed submission (Kenward 2004). The draft received strong objection from businesses, with potentially larger scope for extortion and corruption by unscrupulous tax officials being the main point (*Jakarta Post*, 14/11/2003). As further argued by Kenward (2004, p.16), the draft was so dramatic in terms of change that it might not effectively be translated into large tax collections.

The slow progress of privatisation

Privatisation of state-owned enterprises (SOEs) was another broad reform agenda induced by the IMF, which had been started two years earlier before the Megawati administration period. Notwithstanding its importance in promoting economic recovery,

the progress on privatisation had been very slow. This had been reported in various editions of *BIES' Survey of Recent Development* in early 2000.

Athukorala (2002, p.155) reported that one factor contributing to the slow progress was the government's ambivalent attitude to the whole idea of privatisation. Several arguments underlying the attitude were put forward by some groups within the government. One group believed that privatisation was the way to achieve greater efficiency. Other groups, including nationalists, were concerned with the potential adverse effect on job losses from the privatisation and the potential ownership transfer from domestic to foreign entrepreneurs. The latter was clearly reflected in the strong objection to the government's effort to sell the ownership of *PT Semen Gresik*, to Mexican company Cemex.

Perhaps reflecting a more serious objection towards the idea of privatisation, Athukorala also reported few reverse-privatisation actions by the government. In particular, the government had been buying back the shares of two giant telecommunication SOEs, i.e. *PT Indosat* and *PT Telkom*, from their foreign partners in the companies' various subsidiaries.

In addition to hampering the process of economic recovery, the anti-privatisation sentiment –combined with few other unfriendly policies – seems to have further damaged the prospect for economic recovery, by destroying international market confidence in the Indonesian economy.¹⁶ Similar to the report on privatisation, various *BIES* editions of *Survey of Recent Development* in early 2000 reported a deteriorating foreign investment performance. The anti-privatisation sentiment, therefore, might be argued to have undermined the other positive results from the successful reforms.

2.1.2 The non IMF-related economic reforms

As noted earlier in the introduction and illustrated above, the Megawati administration

¹⁶ The other unfriendly policy was the rising protectionist trend after the crisis. This was also well-reported in the various editions of *BIES* as well as in Soesastro and Basri (2005).

was rather successful in building and maintaining macroeconomic stability. In contrast, the administration was rather unsuccessful in delivering the ‘micro’ reforms as stated in the White Paper. This is in particular in addressing the issue of deteriorating investment climate. Some observers, however, gave some credit to the administration in delivering reforms aiming at improving the implementation of the new regional arrangements after the crisis.

The failure reform to improve investment climate: the case of labour policy

Before describing what had happened during the Megawati period regarding labour policy, it is important to briefly describe the historical context of labour policy making after the crisis.

The most important point to mention is there was a dramatic change in the labour market institutions immediately following the crisis, one aspect of which was a significant improvement in the freedom of labour to negotiate and organise (Hill 2006). This is clearly in contrast to the situation in the Soeharto era (i.e. before the crisis), where labour unions and industrial relation processes were tightly controlled by the government (Manning 1998).¹⁷ But, as noted by Aswicahyono et al. (2004) and Hill (2006), the rising labour market populism seems to have been excessive, and as a result, several new rigid labour regulations were introduced immediately after the crisis.

Two regulations in this regards are the controversial Ministerial Decree 150 passed in 2000 and the rule concerning the determination of the minimum wage. For the former, the Decree set new rights concerning severance pay and compensation. The rights encourage workers to make excessive claims and to resort to strike when their demands are not met (Dick 2001, p. 28).¹⁸ Thus in short, the Decree significantly increases the costs needed to be paid by firms if they are to release some workers. The latter was set as a part of the much bolder decentralisation program implemented in 2001. In particular,

¹⁷ Although it is important to note here the seriousness of the government in the 1990s in enforcing the ruling of minimum wage. According to Manning (1998, p. 228), it was a political strategy aimed at defusing the issue of union freedoms and labour rights by indicating that the government was capable of delivering real gains to workers, even in the absence of free trade unions.

¹⁸ See, for example Dick (2001) and Alisjahbana and Manning (2005) for more detail on the Decree.

the rule shifts the power to set minimum wage from central to provincial governments. In setting the minimum wages, the heads of the regional governments also receive recommendations from tripartite councils in their regions (Suryahadi et al. 2003).¹⁹

In response to the complaints from business sector regarding the Decree, the government drafted a new labour law which, after a lengthy deliberation process in the parliament, was passed by the parliament on 25 February 2003. The law replaces more than ten older pieces of legislation, including the controversial Ministerial Decree No. 150/2000. It was intended to strike a balance between the long years of political repression on labour and the mounting concerns among investors that Indonesia was losing its competitiveness in labour-intensive manufacturing (MacIntyre and Resosudarmo 2003, p. 148). The law was also seen as a compromise between business, represented by the Indonesian Employers Association (Apindo), and a few big labour unions.

While seen as a compromise, the law was still considered pro-labour, i.e., with employment conditions being costly and rigid from an employer's perspective. Therefore, compared to the Ministerial Decree No. 150/2000, the law was still seen as anti-business (MacIntyre and Resosudarmo 2003). As described in Box 3, for example, the concession given to employers regarding the generous severance payment ruled in the Decree is small, and the right to be paid while striking remains, provided the strike occurs in the place of employment and is subject to advance notification.

The failure of the Megawati administration to deliver the needed reforms could be attributed to the excessive swing towards the pro-labour side in regulation making (Aswicahyono et al. 2004). A clear reflection of this perhaps is the fact that the two manpower ministers during the era of Gus Dur and Megawati, respectively, came from labour unions group. Moreover, in a short period of time after the crisis, about 60-plus new labour unions emerged and there was a widespread belief among the unions that it is now (i.e. after the Soeharto era) the time for labour to turn to gain fairer share of the 'development pie' (Alisjahbana and Manning 2002).

¹⁹ See, for example Alisjahbana and Manning (2005) for the detail of the rule.

Box 3**Some key elements of labour law No. 13/2003.**

- It accepts the generous rate of severance and long service pay set out in Ministerial Decree No. 150/2002, with minor concession to employers, such as the maximum severance pay of 9 rather 12 months time a worker's monthly salary. However, employers are not (any longer) required to provide severance pay to workers that resign voluntarily.
- The right to be paid while striking remains, provided the strike occurs at the place of employment and both employers and the authorities are given advance notification. If the strikes violate the procedures, the strikes are considered illegal and without pay, and workers are liable to temporary lockout.
- The law places stricter limits on the use of labour for outsourcing or temporary labour for core activities.
- Minimum wages are set by the provincial governors, not the head of districts, based on a 'fitting' standard living.

Source: MacIntyre and Resosudarmo (2003, p.148-9).

The excessive swing implies an unbalanced representation between firms and unions at the policy-maker level. This can clearly be seen from the absence of flexibility in the post-crisis Indonesian labour market, which is quite in contrast to the labour market situation before the crisis. The literature on Indonesian economic development has recorded that flexibility is one of the important factors in supporting the export-oriented industrialisation in the 1990s (e.g. Manning 1998; Hill 1996). The flexibility evidently played a significant role for firms in surviving the crisis. Manning (2000) and World Bank (2000) consistently found evidence that firms 'hoard labour' in an attempt to minimise costs.

Unsuccessful attempt to improve infrastructure: the case of Electricity Law²⁰

Policy measures to improve the infrastructure were another set of policy priorities in the White Paper. The quality of infrastructure in Indonesia has deteriorated since the crisis. The lack of the country's financing capacity was one of the reasons for the poor

²⁰ This sub-section draws from Soesastro and Atje (2005).

infrastructure quality (World Bank 2005).²¹

The Megawati administration took some policy actions attempting to solve the financing problem. In the energy sector, this is shown by the introduction of the new Electricity Law (No. 20/2002) and Oil and Gas Law (No. 22/2001). These laws encouraged the participation of private firms in both sectors, by unbundling the business activities in the sectors which ideally should attract new players in the industries.

While promising, the introduction of the laws had not been so successful. The Electricity Law was annulled by Constitutional Court in 2003, based on the complaint from the labour union of *Perusahaan Listrik Negara (PLN)*, the state company which has been the sole provider of electricity, and a number of NGOs. These parties opposed the unbundling proposal, which was aimed at increasing efficiency, and argued that the unbundled system (i.e. electricity generation, transmission and distribution) would result in higher prices for consumers than those under the *PLN*'s vertically integrated operation. They further argued that the opening up of the distribution activities would violate the spirit of Article 33 of the National Constitution.

With the annulment, the previous electricity law came back into force (i.e. No. 15/1985) which, in principle, does not allow any private participation. In other words, *PLN* was still the sole operator in the electricity sector. This, obviously, was an anti-reform result, since the efficiency goal – implied by the unbundling – was not achieved. In addition – and perhaps is more importantly – the annulment washed out the positive reform momentum to reform institutions. This is because the new law also included a proposal for an independent regulatory body, i.e. the Electricity Market Supervisory Board, which was designed to review all regulations affecting the electricity sector.

While it might not be important, it is worth mentioning that the Constitutional Court was a new institution established after the crisis. The Court has the same legal position as the

²¹ The other important reason is the coordination problem with the regional governments, due to regional autonomy. In particular, there are overlaps between the various government institutions (i.e. between the central and the regional governments) in the provision of infrastructure.

parliament and was established to provide a kind of ‘check-and-balance’ mechanism for the laws produced by the parliament.

Similar to the Electricity Law, the Oil and Gas Law also received challenges from the Constitutional Court. The Oil and Gas Law in principle introduced the same proposal as in the Electricity Law. A complaint was made by the labour union of *Pertamina*, the state-owned monopolist, for job security reasons. However, unlike the Electricity Law, the Oil and Gas Law was not annulled. The Court merely recommended that certain articles to be modified. One reason for the different outcome is that the Court seemed to have realised the importance of a supervisory board, which was also established in the Law.

The experience described above illustrates the importance of strong and capable institutions to ensure a credible policy reform. The failure in passing the Electricity Law was unlikely to have come from the content of the law. In fact, the law sent a very strong signal for reform, owing to the promotion of higher participation of private sector and an establishment of an independent regulatory body in for the sector. What we can learn from this particular experience perhaps is the importance of capacity building needed by new institutions. As described, although the aim of both laws is in principle the same, the end result is different between the two. This suggests the lack of understanding by the Constitutional Court in the policy idea proposed in the laws. While this might be true, the difference might also be because the Court had not had enough experience in handling their task. As noted, the Court was a new institution at the time when both laws were reviewed.

It is important to note here, however, that the strong opposition from the bureaucrats and workers in the *PLN* might be another important factor contributing to the unsuccessful reform. Thus, similar to the case of slow progress in the IMF-induced privatisation program described earlier, it can be concluded that economic reforms involving wide public or nationalistic interest are still difficult to achieve.

The reforms to improve regional autonomy

Another major policy reform done in the Megawati administration was the introduction of two new laws governing regional autonomy, the law No. 32/2004 and No. 33/2004, which replaced the old laws of No. 22/1999 and No. 25/1999, respectively.

According to Brodjonegoro (2005), the most important breakthrough in the new law that governed the economic decentralisation (i.e. law No. 33/2004) is the elimination of the so-called ‘no-harm’ clause. Based on the three-year implementation of the regional autonomy program, the clause evidently failed to reduce the fiscal imbalance between regions. In short, the elimination of the clause ensures that the worse-off region would have enough funds to finance their basic public expenditure, while the well-off regions (i.e., those with abundant natural resources) would not be given additional assistance from the central government to finance their public expenditure.

Related to this, the new law also improves the rule for determining the size of the ‘fiscal gap’, which is the gap that determines the intergovernmental transfer (i.e., from central to regional government) and hence the size of fiscal imbalance. Most important in this respect is the inclusion of more rigorous determining variables, such as Regional GDP and Human Development Index (HDI), to replace the poverty variable used in accordance with the old law (i.e. the law No25/1999).

Despite this major improvement, the new law did not really address the issue of incomplete fiscal decentralisation. According to some researchers, the old decentralisation law only intensified decentralisation in the expenditure side of the local government budget, and not in the revenue side. Local governments still do not have authority to impose significant taxes, such as income and property taxes, which potentially could reduce the dependency of local on central government.

While there was a rather successful reform of the economic aspects of decentralization, via law No. 33, there was a rather unclear message delivered from a political perspective, via law No. 32. According to few observers, the law is seen as an attempt by the

government to regain some of the authority and functions that had been devolved to local governments by the old decentralization laws (Soesastro and Atje 2005). This is illustrated, for example, by some articles in the law that enhance the role and authority of governors vis-à-vis the heads of local government (districts/municipalities).

2.2 Susilo Bambang Yudhoyono administration period

Susilo Bambang Yudhoyono was installed as the nation's sixth president on 20 October 2004. He assumed power under a favourable environment, at least in the short term. On the international economic front, global economic growth in 2004 was predicted to be the highest in 30 years. International energy prices were at record levels, while interest rates remained historically low. On the domestic political economy front, it seemed that SBY could face serious obstacles in getting his reforms through parliament since his Democratic Party had very small direct representation in the parliament — fewer than 10% of the members. However, unlike the the three previous administrations, the new president has been granted a strong democratic mandate through a fair and transparent electoral process. Moreover, SBY incurred few political debts. All of these can be seen as an unparalleled opportunity for SBY to bring the country to high growth.

However, although the opportunities are immense, the challenges are also daunting. Megawati's administration was able to restore macroeconomic stability, but microeconomic performance was dismal. Recorded foreign direct investment (FDI) continued to be negative in the first half of 2004. Indonesia is the only crisis-affected economy in Asia in which investors — foreign and, more importantly, local — are still essentially holding back. They wait for clear signals that this is a government with the determination and capacity to deliver a predictable, growth-oriented policy environment.

Substantial political and economic changes in recent years have implications for how the institutional arrangements that underpinned past liberalization might operate in the future. There are three broad changes since the fall of Soeharto. First, greater authority has shifted from the President to Parliament. Second, key economic ministers are less connected by shared views and constituencies. Third, decentralization has shifted much

responsibility to the regions. As a result, policy decision-making has become fragmented, with each ministry or local government operating according to its own agenda and without a common vision.

There were several economic policies that will be used by the public as a yardstick to evaluate the likely performance of the new administration. First, the likelihood of success will be judged on the basis of the composition of the new cabinet, especially the finance, coordinating economics, trade, industry, state enterprises, attorney general and labour portfolios. Second, the public will evaluate major statements on broad development objectives. Third, the public anticipated quick-acting reforms to demonstrate to the business community the government's serious intent. Fourth, the public will judge whether the medium-term development plan is coherent and addressed the key issues, such as the deteriorating quality of physical infrastructure, partial labour market deregulation, targeted social programs, sweeping administrative simplification, and clarity in centre–region relations.

The composition of the cabinet has been rather disappointing. The Coordinating Minister for Economic Affairs, Aburizal Bakrie, is well known for the privileged position during and beyond the Soeharto era. The Minister of Finance, Jusuf Anwar, is an experienced bureaucrat but may not have political skills to make much headway in this most difficult portfolio. Two most capable ministers Sri Mulyani Indrawati and Mari Pangestu hold relatively less important planning and trade portfolios. It is surprising that SBY did not capitalize on his strong democratic mandate to form a “professional cabinet”. Instead, he assemble a compromise cabinet (also called kabinet pelangi - rainbow cabinet) in order to gain support from major parties and to accommodate the various regional and ethnic demands for ministerial representation.

To respond to the public expectation that the government will move quickly, SBY instructed his ministers to formulate 100 day programs. The agenda focuses on three objectives: to improve investment climate, to maintain macroeconomic stability, and to raise public welfare and eradicate poverty. These three broad objectives were translated

into various goals to be achieved through various programs and actions. Through these agendas the government wants to give a clear signal on the importance of improving the investment climate. However, the detail of the programs was not made public and became an internal working document.

Unfortunately, the implementation of the program did not reflect the government willingness and ability to deliver its promises. First, there were no clear signals that the government has strong determination to act consistently and to implement a necessary but unpopular policy. For example, the decision to put off the proper resolution of the long running Cemex-Semen Gresik dispute, clearly shows the business community, that the government willingness and ability to improve investment climate is limited. Second, the fact that the detail of the programs was not made public prevents the public from knowing about the direction of the country's development for the next five years. Moreover, performance cannot be objectively evaluated by outsiders.

Infrastructure Challenges

As a result of economic crisis, infrastructure has been deteriorating rapidly. Box 4 provides the World Bank's estimate on the magnitude of infrastructure problems. World Bank also suggested three main explanations for Indonesia's poor infrastructure. First, the economic crisis of 1997–98 dramatically reduced the country's financial capacity to maintain infrastructure and make new investments in it. The Bank estimated, for example, that only 3% of GDP was allocated for infrastructure maintenance and development in 2002, down sharply from 7% in 1996. Second, even before the crisis, infrastructure development was held back by poor institutional and regulatory frameworks, and by corruption. Third, local governments have been given control of infrastructure under regional autonomy, but they are not being provided with adequate funds for infrastructure development; in addition, there are overlaps between the various levels of government in the provision of infrastructure.

Box 4**Infrastructure challenges****Water and Sanitation**

- Water access is low-22% of the population does not have access to ‘improved’ water, and only 14% are connected to municipal water supplies.
- Sanitation services are lacking-only 1.3% of the population are reached by sewerage networks.
- Municipal water companies (PDAM’s) are struggling-over two-thirds are loss-making; water unaccounted for is over 40%; and tariffs are well below cost.

Telecommunications

- Fixed line access is the lowest in the region-covering only 4% of the population
- Massive investment is needed, but finding is a challenge-raising teledensity by just 1% will cost \$330 million.

Power

- Access is low-currently, 43 % of the population is without power (roughly 90 million people, including many of the poorest).
- Investment needs are high- an estimated \$ 15-17 billion is needed before 2012 to provide an additional 9,700 megawatts of generation capacity, plus expanded transmission and distribution for 1.6 million connection annually.

Roads and Road Transport

- Spending has declined- from 22 % of the national development budget in 1993 to 11 % in 2000.
- Maintenance is lacking- the proportion of the road budget allocated for maintenance fell from 30 % in 1985 to below 10 % in 2000.
- Congestion is a problem- significant capacity expansion is needed, but little has been added, and urbanization trends will only worsen the problem (as suggested by rapid growth in the number of vehicles on the roads).

Source: World Bank (2005), taken from Soesastro and Atje (2005).

Clearly, the investment needed to tackle such a huge problem is enormous, ranging from 5% of GDP (\$70 billion) to 10% of GDP. The government estimated that only 33% of the necessary total expenditure could be financed domestically. The remaining 67% should be financed by either/or multilateral/bilateral donors or foreign private investors. It is estimated that only 7% of the needs could be financed by ODA. The remaining gaps, amounting to Rp. 400-600, need to be financed by foreign private investors.

Therefore, the success of the government in tackling the huge infrastructure problems hinges on the ability of government to attract domestic and foreign private investors to invest in infrastructure. This in turn requires a clearer overall strategy and greater certainty in relation to the regulatory framework. In the previous section, it was noted that Megawati's government enacted various regulatory frameworks: a new telecommunication law in 1999, a new oil and gas law in 2001, a new electricity law in 2002.

However, these regulatory reforms were not fully effective for several reasons. First, there are either no clear objectives, or there are multiple objectives with no specification of what are the main and secondary objective. In the case of telecommunication law, for example, the objective is to introduce competition. But there are also other objectives such as to attract private investment, and to privatise the state-owned telecommunication company for state budget purposes. It is believed that the government reluctance to introduce full competition is based on the belief that monopoly profits for the telecom company are necessary to make the company attractive for the prospective buyer(s).

Second, the implementing regulation, the complementary regulation, and the institutions to carry out the reform are not there, long delayed, or not carefully designed. As a result, the reforms become ineffective or create uncertainties. For example, one of the bottlenecks for toll road investment is the difficulty and the high cost of land clearing. Yet the draft regulation on land clearing attracted negative comment, based on the fear that the regulation may be misused to acquire land cheaply for the benefit of powerful interests. After long delay, finally the regulation was passed in May 2005. The regulation stipulates that land may be compulsorily acquired by governments for a variety of development purposes if an acceptable price cannot be agreed upon by negotiation.

Third, reform is undermined by actions of different institutions that have different ideological views, and vested interests such as the incumbent SOE monopoly, or local governments. The example for this is the cancellation of the electricity law (No. 20/2002)

as reviewed earlier.

Finally, there is also a problem of infrastructure pricing policies. McLeod () points out that the private sector will not be interested in providing these kinds of infrastructure services unless it can be confident that its revenues will exceed its costs. Therefore, it requires that the government implement a “user pays” principle. However, investors have learned from the past that the government faces political difficulties every time it wishes to raise infrastructure sector prices under its control.

Despite the regulatory weaknesses, there are several attempts to attract infrastructure investment. The government held an infrastructure summit in Jakarta on 17-18 January 2005. At the summit, the government offered 91 infrastructure projects to the private sector, involving a total investment estimated at \$22.5 billion. Tenders were to be opened for bidding in the first week of March 2005 but, as of the middle of February, out of 91 projects only nine projects had been declared ready for tendering. The government is being excessively optimistic—indeed, it seems to have been carried away by this new enthusiasm for private sector involvement in infrastructure—in planning for a second batch of over 40 even larger projects, with an estimated investment value of \$57.5 billion in aggregate, to be offered in November 2005. Only the World Bank, the Asian Development Bank and Japan expressed an interest in investing considerable sums in infrastructure at the summit. There is also the question of absorptive capacity, since Indonesia’s ability to absorb project assistance has been low and declining during the past few years.

Policy Package for improvement of the investment climate

The long awaited “Policy Package For Improvement of the Investment Climate” was announced on 2 March 2006. The package contains 85 regulatory and institutional reforms that the GOI plans to take in 2006 to improve the investment climate. It focuses on five areas: General investment policies; Customs, excise and duties policies; Taxation; Labour; and Small and medium enterprises (SMEs).

Salient features in the package include submitting a revised investment law to Parliament by March 2006, and submitting revisions to the Manpower Law (No. 12/2003) to Parliament by the end of April 2006. The revised law would address business community concerns about worker severance costs, outsourcing and expatriate work permits.

It is expected that the government and the parliament will reach a decision on the status of three draft tax laws now before parliament by the end of April 2006. The reform also mentions the revitalization of the “National Team for the Enhancement of Exports and Investment” (PEPI) to better coordinate investment policies and help solve high profile investment disputes "quickly, cheaply and fairly".

The Ministry of Finance will accelerate customs processing times by June 2006 to 30 minutes for green lane shipments and three days for red lane shipments, and a reduction of the use of the red lane to just 10 percent of shipments by December 2006. The Ministry of Finance will establish tax facilities for certain business sectors by the end of June 2006, and revise rules and regulations on value added taxes (VAT) to coincide with passage of a package of amended tax laws.

The investment package also plans to simplify licensing in commerce by March 2006. According to the package, the licensing regulations to be simplified include: Trade Business License (SIUP), Trade Company Representation License (P3A), Surveyor Business Activity License (SIKUS), Modern Market Business License, Franchise Business Registration Document (STPUW), Agency and Distributor Registration Document, Alcoholic Beverages Trade Business License (SIUP-MB), Multi level sales business license (IUPB), and Warehouse Registration Document (TDG). To meet the investment package requirements, the MOT issued decrees on 4 April 2006. The decrees simplify application procedures and eliminate some bureaucratic requirements for those licenses. However, probably due to the sensitivity of the issue, the Modern Market Business License has not been reformed.

Manpower Law

For several years the business community has expressed their grievance regarding Indonesia's rigid labour law. World Bank's "Doing Business Report" indicates that Indonesia's labour market is among the most rigid in the region. The concern includes high worker severance costs, difficulty to outsource and hire contract workers and difficulty in obtaining expatriate work permits. The investment package address these issues and stipulates that the revision to Manpower Law (No. 13/2003) has to be submitted to Parliament by the end of April 2006. However, the resistance to the revision is very strong, and demonstrations and strikes escalated prior to the submission of the draft law to the parliament. The government succumbed to the pressure and dropped its plan to submit the revised version of the manpower law to parliament and will formulate another bill through the tripartite (government, businessmen and workers) forum. To give a sense of objectivity and to design a better system and law on manpower, the President also plans to initiate a study involving at least five higher learning institutes.

Investment Law

A new draft investment law has been submitted by the Minister of Trade to Parliament on March 22. If the draft passes the Parliament, the currently separate laws for foreign and domestic investors would be unified. The draft also provides traditional investment protections including national treatment, the right to repatriation of profits, and a guarantee against nationalization.

The law will also shift the emphasis of the current approval system to a registration system. However, the shift would mean the removal of the right of the current Coordinating Board on Investment (BKPM) to grant approval. Initially, it was planned that the BKPM will be given a new role as a promotion agency. It is to be expected that the final result will be a compromise in which BKPM will still retain some right to grant approval. Another complication with the new investment law is that it should accommodate the new decentralised system in which a majority of central government responsibilities has been transferred to local governments.

Accompanying the new Investment Law, the government of Indonesia also plans a

number of other regulatory reforms including a clearer, simpler, and more transparent criteria for the negative investment list. It is important to note that the draft regulation on the negative investment list for the first time requires some sort of regulatory impact assessment in choosing which sectors or activities should be included in the negative list.

Another regulatory reform that will accompany the new Investment Law is the investment procedure regulation. The regulation contains a more streamlined and transparent investment procedure. The registration approach is also manifest in this regulation. It is expected that the new procedure will reduce the number of days needed to establish a business from 150 days to 30 days, and will give more certainty and transparency for the business community.

The third regulation would provide a system of one-stop service for investors. This regulation, together with the revisions to Government Regulation 25 on the responsibilities of local governments in the area of investment, is expected to clear the confusion regarding the role of central government vis-à-vis local government in the area of investment.

Six months has elapsed since the announcement of the investment package. There are fourteen policies that have not yet been implemented, and question about the effectiveness of the policies that have been implemented. The slow progress in the implementation of the investment package is the result of lack of capacity and coordination between departments, and the slow progress in the parliament. The chronic coordination problems seem to surface every time a new package is announced, reducing the effectiveness of the reforms.

3. Summary and few lessons learnt

The previous section has reviewed the experiences of undertaking economic reforms during the Megawati and SBY period. To briefly summarise, it appears the Megawati administration was quite successful in maintaining and improving the macroeconomic stability. The administration, however, seemed less successful in undertaking

microeconomic reform. As noted, the investment climate in the country deteriorated during the Megawati period. A task to improve investment climate has been the legacy of the Megawati administration, and became the main policy agenda of the SBY administration. As reviewed, the SBY administration has proposed several bold and quite ambitious policy reform initiatives to restore the investment climate. While promising, the implementation of the initiatives evidently has not been so effective and successful.

Having reviewed the reforms, we attempted here to draw some important points on the factors that determine the success of undertaking reforms in Indonesia after the crisis.

First, the role of IMF is very important in paving the way to deliver a successful reform and ensuring that the reform is appropriate and meets its objective. The amendment of the central bank law and the passing of the state finance law were two bold examples in this respect during the Megawati period. As noted, the Megawati period was quite successful in maintaining macroeconomic stability, which to large extent could be attributed to the result of the central bank law.

Second, undertaking reforms tends to be quite difficult when it involves strong public or nationalistic interest. The experience of the privatisation reform agenda and nullification of the electricity law, as well as the relatively long period of deliberation of draft laws in the parliament, clearly illustrate this point. Related to this, MacIntyre and Resosudarmo (2003) noted that the long process of law deliberation in the parliament reflects the fundamental change in the Indonesian political architecture immediately after the crisis, where there had been a significant power shift from president to the parliament. The implication is that, as often the case, the days of quick and decisive action on major policy reforms no longer applies in the post-Soeharto era (MacIntyre and Resosudarmo 2003, p. 153). There would not be significant reforms unless an agreement between the government and the parliament is reached.

Third, in many cases, unsuccessful reforms might be caused by the absence of supporting institutions to carry out the reforms or the other complementary reforms. As a result of

the absence, reforms often become ineffective and are surrounded by many uncertainties. The absence of draft regulation on land clearing, which hampers the momentum to improve infrastructure (i.e. toll roads), illustrates this point.

Fourth, reforms are often challenged by coordination problem. As noted, one explanation for the slow policy implementation and ineffectiveness of reforms is the fact that policy decision-making has become more fragmented after the Soeharto era.

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