Economic Reform and Weak of the Institutional Change in Indonesia

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Introduction

It appears that today is the right moment to reflectively and clearly examine the Indonesia economy journey post-crisis 1997/1998. At least there are two rationalizations for placing the 1997/1998 crisis as a starting point to review the national economy. *First*, the crisis period was dreadfully powerful that it crushed all the joints of economy, despite the fact the trigger started only from the monetary side, particularly the exchange rate. The crisis not only shock the foundations of the financial sector, but also eroded the real sector constructions. As a result, the economic growth plunged to minus 13.1% in 1998 (Nasution, 2001:158). *Second*, over crisis the national economy portrait changed drastically, mainly due to economic reform policies. Normatively, the landscape of national economy becomes more market friendly, opened, and decentralized. In the process, the reform policies were driven by two main forces: the external institutions and domestic aspirations.

Economic Crisis: The Political Economy Perspective

Since the 1980s, the dynamics of the world economy had been running rapidly. It was not just happening in developed countries, but also in developing countries. In the region of Southeast Asia, for example by taking data in 1996 (before the 1997/1998 crisis), economic output achieved high economic growth and stable. During this period the economic growth in Indonesia, Malaysia, Philippines, Singapore, Thailand, and Vietnam the average were always above five percent annually. Conversely, the more encouraging, the inflation rate had successfully been pushed to less than two digits, which also indicated the existence of price stability in the region. This stable inflation led to the assurance of business for investors, while for consumers (the public) the purchasing power were quite strong for not being eroded by the rising prices. The meet between the positive expectations of capital owners and the consumers purchasing power was what sustained the economic growth in Southeast Asia at that period of time.

Yet, all of a sudden in mid-1997 economic crisis attacked the Asian region and continued to spread to other countries (Stiglitz, 2004:5). The economic crisis was triggered by the collapse of the exchange rate of Bath (Thailand) towards the U.S. dollar on July 2, 1997 (Charoenseang dan Manakit, 2002:597).[2] Thereafter, the exchange rate depreciation which couldn't be isolated spreading (contagion effect) fast to Malaysia, Indonesia, South Korea, and others. Noted, the stock price index in Thailand fell by 80% and its currency devalued by 100%; stock price in Indonesia dropped by 60% and the currency severely devalued by 600%; while in South Korea stock price fell by 65% and its currency devalued by 100% (Jang dan Sul, 2002:94). From these data can be seen how dreadful the impact of the monetary crisis so that affects overall economic performance, including the real sector.

There are numerous versions regarding to the economic crisis itself. Charoenseang and Manakit (2002:598) explore at least two points of view noticing the triggers of the 1997/1998 crisis. *First*, the view which argues that the fragile economic fundamentals and inconsistent policies as the main source of crisis. This perspective is often referred to as "first generation model" [developed by Krugman (1979) and Flood and Garber (1986)] which describes currency crisis as a result of fundamentals inconsistency in formulating domestic economic policy.

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[2] The crisis in Thailand actually had been started in June 1997, marked by the fall of stock prices sharply. See Hoyoon Jang and Wonsik Sul, The Asian Financial Crisis and the Co-movement of Asian Stock Markets, *Journal of Asian Economics*, Vol. 13, 2002, p. 95

Second, the belief that the source of crisis is none other than the panic which occured in the financial sector (financial panic) that interacted with the expectations of economic agents soon had direct impact towards macroeconomic policy. This explanation is often called as "second generation model" [introduced by Obstfeld (1996)] which gives generic description explanation of the theoritical relationship between macroeconomic model with rational expectations, which is believed that the expectations that occur in the market directly affect the decision making of economic policy (see also Roubini and Mihm, 2010:29).

In Indonesia case, the truth of "first generation model" view can be tracked after seeing the situation of the national economy fundamentals. Indrawati (2002:578), for instance, reveals that the period before Indonesia economic crisis is marked by the vulnerability of the banking sector and the corporate structure. Conglomerate business grew aggressively and dominated entire economic activity in almost all regions in Indonesia. Most of the banks owned by conglomerates who used the bank to finance their single-parent companies, therefore often broke the legal lending limit regulation. State enterprises (BUMN) were also forced to deviate to finance government projects in which the feasibility studies were not clear or high-risk projects (that belong to the president's cronies). Thus, although applying the principles of poor governance and lack of transparency (and public accountability), these corporations continued their business expansion by using banks and other sources of debt from abroad. This practice met with the imprudent banking management and poor credit policies and so created financial risks, both on the company and the bank itself.

Meanwhile, according to the second approach (second generation model), the economic crisis in Indonesia would not spread rapidly and experience severe deepening if the government did not take the decision to liquidate 16 banks (as recommended by the IMF) in November 1997.[3] This policy is considered greatly simplifies the problem, because the IMF believes the banks are small, contributing only about 2.5% of total banking sector assets, so it certainly will not create excessive complication problems (Indrawati, 2002:582). The IMF does not take into account the reality that the policy was taken when the crisis and public reliance in the economy (particularly banks) were in the lowest point.[4] As a result, once the liquidation policy done the customer withdrawals did occur on a large scale (rush) so that banks experiencing liquidity problems. The accumulation of a series of policy led the economy to collapse and the policy makers lost control to address them.

Reversed Economic Reform

There are perhaps no other international institutions that more influential than the World Bank and the International Monetary Fund (IMF) in promoting economic reform (Addison and Baliamoune-Lutz, 2006:1029; Shafaeddin, 2005:3). Both institutions are formed during the Bretton Woods conference after the World War II, with the main objectives to reconstruct the world's infrastructure and assist the development of member countries. Interesting to consider that these two institutions also have other important functions, namely blocking the influence of socialist countries in expanding the idea and its economic system, especially to the third world countries (Kloby, 1997:171-172). Thus, it is not surprising since the beginning these institutions are very keen to channel funds (foreign debts) to the third world countries with fairly soft requirements (soft loan), namely low interest rate and payment grace period of time.

Williamson compiles the policies which aim to formulate economic reform policies and calls it Washington Consensus. Washington Consensus is based on economic stabilization efforts through structural adjustment policy which is recommended by the Bretton Woods organization and the U.S. government's economic policy makers. Washington Consensus emphasizes on the creation of prudent financial and macroeconomic policies, competitive currency exchange rates, liberalization of financial and trade sector, privatization, and deregulation (Rodrik, 1996:17; McCleery dan De Paolis, 2008:438).

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[3] The IMF's policy itself is generally criticized for being too broad in scope, not focused, ambitious, and unrealistic in terms of time, particularly associated with Indonesia's political transition which still vulnerable (at that time) and the capacity of government still weak to implement the program with a tight schedule. See Sri Mulyani Indrawati, Indonesia Economic Recovery Process and the Role of Government, *Journal of Asian Economics*, Vol. 13, 2002, p. 580

[4] In general, the IMF and World Bank were actually seen had no sufficient information about the domestic political situation of the country which aimed to be helped rather than political actors in the country concerned. See Tony Addison and Mina Baliamoune-Lutz, Economic Reform When Institutional Quality is Weak: The Case of the Maghreb, *Journal of Policy Modeling*, Vol. 28, 2006, p. 1030

The policy implicitly calls on the government/state to refrain from interfering directly in economic activities, but rather more focused on monetary policies, securing property rights, and setting up the infrastructure of basic education. In implementation, there are "two fortresses" in designing economic reform, namely Asian fortress and Eastern European fortress. The "Asian Approach" tends to designing economic reform through successive stages. Ghai (1997:33) mentions the term "gradual yet systematic". This approach is focused on "bottom-up" strategy and puts the reform at the microeconomic level, like institutional reform (reform in agriculture sector and industrial businesses reform) and pricing reform; preceding reform at macroeconomic level (fiscal, monetary, and foreign trade reform). On the contrary, the "Eastern European Approach" tends to work on economic reform through radical changes (big-bang approach), as seen in changes of property rights, elimination of price controls, as well as exchange rate liberalization and trade (Ghai, 1997:33).

Subsequently, in designing the company performance improvements, treatment towards state enterprises in particular, the Asian Approach attempts more efforts to the expansion of autonomy and accountability. While in Eastern European countries prefer the way of privatization to reform the state enterprises performance. Can be drawn from this case a statement that Asian countries consider that what a corporation needs to develop itself is the existence of autonomy and accountability, the problem lies not in ownership: owned by the state or private. Conversely, Eastern European countries spot that the market (private) will be able to effectively and efficiently promote a company than when running by the state. Seen here different basic assumptions between the two approaches in improving the performance of its state enterprises.[5]

If the description above being related to the situation in Indonesia, then it is actually practicing reversed economic reform, in which government pushes on macroeconomic level in the first place, exactly as it was practiced in the Eastern Europe. *First*, the government had drastically changed the ownership of economic resources into private ownership (private property rights), including economic resources that should be owned and controlled by the state. *Second*, price controls are removed one by one, particularly with respect to agricultural commodities, while the production and distribution institutional has not fully reached by government. The implication, food commodity prices soar, but the profit takers are the economic players in the downstream sector (instead of farmers). *Third*, liberalization is run extensively to most economic sectors, particularly finance and banking sector. Liberalization of the financial sector makes the economy more easily be shaken if external instability occurs. *Fourth*, the privatization strategy is more preferred by government to build a corporate culture and state enterprises efficiency. The government believes the private sector (domestic or foreign) are better able to improve the performance of the dying state enterprises.

More systematically, if the economic reforms in Indonesia put into hierarchy, it can be read by the following three levels. *First*, economic reforms on the macro layer in the 1980s when several economic sectors (manufacturing, banking, transportation, etc.) were deregulated and liberalized sufficiently massive (McCawley, 2002:262; Indrawati, 2002:578). The development of the banking sector and capital market become an important marker of the outcome of deregulation, so that life and death of the economic activity and the household behavior cannot be separated from the development of the financial sector. This deregulation and liberalization are followed by the real sector and trade, while the issuance of Government Regulation No. 20/1994 on "*The Ownership of Shares in a Company which is Established in the Framework of Foreign Investment*" which grants flexibility to foreign economic actors throughout the corners of the national economy. This regulation is designed to answer the very large investment (to feed the purpose of economic growth and job creation), while capital and domestic economic players as lacking adequate capacity.

[5] Besides, there are several essential discoveries as an explanation for the occurence of economic reforms in Asia and Eastern Europe. Those explanations include: (i) agriculture sector and medium/small industries can be used as a base advantage for the national economy; (ii) the assumption that the free market will be able to run rapidly is wrong. Measurable phasing step is an important condition for the evolution towards the market system; (iii) the creation of opportunities for private enterprises and developing business behaviour (corporate governance) for state enterprises are more important than privatization; (iv)export-oriented trade policy will improve efficiency and competitiveness, and increasing investment and growth prospects; (v) gradual reform can run only when the social and political situation do support; and (vi) fiscal and monetary policy are less important in the short and medium term. Institutional and price reform are more useful in this phase. Dharam Ghai, *op. cit.,* p. 33

Second, economic reforms at the medieval level, that designing the management of economic (political) development which began to decentralized, was then known as regional autonomy. Centralization management in the past is seen as a source of the stagnation of economic development, in which the current potential that is achieved should be more greater than it is. The targets of economic (fiscal) decentralization in Indonesia in general are (Simanjuntak, 2002:165): (i) meet the aspirations of the local government regarding to the control over financial resources of the state; (ii) promoting accountability and transparency of local government; (iii) increasing the society participation in the process of regional development; (iv) reducing interregional inequalities; (v) guaranteeing the implementation of public services in each region; and (vi) enhancing the society welfare in general. Although this model is seen to have considerable political risks (including the issue of separatism), but still being chosen for it is considered as the most rational way to take care of the Indonesia economy (politics).

Third, reforms at the micro level of the economy running in a healthy condition, which is defined in the Act No. 5/1999 on "Prohibition of Monopolistic Practices and Unfair Business Competition." Before the period 1997/1998, the national economy was known distorted since the economic control held by a handful of economic actors. The economic structure that very monopolistic and oligopolistic was such plural view in almost all sectors of national economy before the economic reform period.[6] The implication of these economic practices leads to low economic competitiveness, access to most economic actors closed, and the public (consumers) harmed. Therefore, changes in the economic competition system is like an effective therapy to design the economy toward a healthy competition so that all economic actors have equal access, the public (consumers) could gain benefit, and the competitiveness is expected to raise.

The Cost of Economic Reform

It must be acknowledged that the economic reform policies have gained a lot of economic progress during the last decade.. The most striking success is the attainment of macroeconomic stability in the last decade, though it was interrupted in certain years due to economic turbulence, such as in 2005 and 2008. In 2005 the economy wobbled due to higher oil and food prices in international market. As a result, in that year inflation figure perched on 17.11%. Meanwhile, in 2008 a devastating financial crisis epicentered in the United States occured due to subprime mortgage case (Stiglitz, 2010:2). The crisis also brought down the economy quite deep, such as falling exports, unsteady financial/banking sector, and deceleration of domestic economy activity. Even, later on the 2008 crisis brought out to the banking problems which led to a political issue, namely the case of Century Bank. However, despite the events in 2005 and 2008, macroeconomic stability relatively maintained, this can be seen from the indicators of economic growth, inflation, interest rates, exchange rates, etc.

Nevertheless, there are other economic issues that can not be solved, even in some certain level deterioration occurs, though the economic reform project has been carried out more than a decade. *First*, there is a tendency that becomes more real for the high growth that is achieved goes along with the rising of income inequality among individuals/groups or interregional.[7] This reality is certainly pathetic, because then the policy reforms just prosper a handful of economic actors or some regions.

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[6] A study conducted by Kuncoro and Abimanyu in 1995 mentions that 7 of 9 sub-sectors of manufacturing industry in Indonesia has a concentration ratio over 40%, so relatively concentrated or oligopoly. Only the textile, apparel, leather and wood products which have relatively low concentrations, i.e. between 13-14%. As for the industrial sub-sectors of food, beverages, tobacco, paper, chemicals, nonmetallic mineral products, basic metals, metal goods, machinery and equipment, and other processing showed that very high concentrations, i.e. between 40-82%. See Mudrajad Kuncoro and Anggito Abimanyu, *Struktur dan Kinerja Industri Indonesia dalam Era Deregulasi dan Liberalisasi: Sebuah Catatan Empiris*, FE UGM, Yogyakarta, 1995, unpublished

[7] The Central Bureau of Statistics (BPS) data shows, in 1971 Java GDP accounts for 54.5% of GDP, followed by Sumatera (29.0%), Sulawesi (6.0%), Kalimantan (5.4%), Bali and Nusa Tenggara (3.4%), and Maluku and Papua (1.7%). In 2008 most of the GDP contribution of these regions decreased, except for Java and Kalimantan. In more detail, in 2008 GDP contribution of Java (60.7%), Sumatera (21.6%), Kalimantan (8.8%), Sulawesi (4.6%), Bali and Nusa Tenggara (2.7%), and Maluku and Papua (1.6%). For the record, the distribution of GDP contribution does not include East Timor. See Suahazil Nazara, *Pemerataan Antardaerah sebagai Tantangan Utama Transformasi Struktural Pembangunan Ekonomi Indonesia Masa Depan*, Inauguration Speech of Professor of FE UI, March 10, 2010, p. 12, unpublished

Second, deregulation and liberalization are considered as effective instruments for improving economic efficiency, but efficiency and competitiveness of national economy just do not move forward in proportion to the acceleration of liberalization. *Third*, the access of labor force to enter the formal sector becomes more narrow so that the proportion of workers who work in the informal sector increases time after time. In other words, the business competition that has been set yet cannot boost the economic capacity and leads to small amount of employment.

There are two important arguments for investigating the failure of some of the economic reform programs in Indonesia. First, the analysis focused on the choices and sequence of economic reform policies. This approach believes that the choices of policy reform across countries cannot be made homogeneous because each country has its characteristics and different economic problems. The economic reform model of "Asia" and "Eastern Europe", as it has been reviewed in advance, is a response to the different economic characteristics accross these countries. Second, the reason of the weakness of the design and institutional enforcement (rules of the game) as a complement of policies that have been produced. This approach on macro level (institutional environment) concentrated on drafting the legal, economic, and politic framework so that the policies will be able to reach the targeted goals. Meanwhile, at the micro level (institutional arrangement) this institutional approach specifically designs rules that enable all economic actors to compete or cooperate fair [(Tian, 2001:387; Kherallah and Kirsten, 2001:4; Groenewegen, et. al., 1995:5)].

In Indonesia case, the first wave reform actually touched the financial sector, especially capital controls. Since the beginning of the New Order era capital controls are removed so that the flow of foreign capital (portfolio and direct investment) milling about freely. It was passed in the decade of the 1980s when the banking sector given the freedom to open branches and ease of foreign banks to operate in Indonesia. Financial sector liberalization policy was executed when the trade sector were still blanketed by protection practice and thick monopoly climate. At that time, the role of the technocrats of the pro-market tend to decline and nationalist economist group rose, so the protection policy attained its stage. In other words, financial sector liberalization in Indonesia preceded the trade sector.

Subsequently, the base of the Indonesia economy are in agriculture, industry, and trade (contribution to GDP is almost as high as 60% and the employment about 71%) [BPS, 2011] with average major problems of narrow land ownership in the agricultural sector (and the weak bargaining position of farmers), low local content in the industrial sector, and economic dominance of large-scale economic actors in the trade sector. In the economic reform agenda, the problem was resolved by the release of price control policy on most agricultural commodities, the promotion of non-tradable sectors, and the creation of broad access to major trade sectors to open business up to districts/villages level. These economic reform policies did not affect the macroeconomic performance, even in some cases actually sustained economic growth rapidly, but at the expense of other economic goals.

Serious implications of economic reform policy can be read at these five following displays. *First*, financial liberalization just becomes an instrument to feeding the interests of the financial sector itself; rather than growing the real sector. Some of the banking funds (domestic and foreign) are not channeled in the form of credit, but it is parked in the SBI (Bank of Indonesia Certificate) and SUN (Government Securities). Bank of Indonesia report shows until May 2010 the banking funds placed in SBI reached Rp 253.6 trillion (App. US$ 27 billion), placed in BI Deposit Facility (FASBI) a number of Rp 47 trillion, and invested in securities (plus other receivables) amounted by Rp 333.3 trillion (BI, 2010:33). *Second*, farmers fall deeper because prices controls had been removed, while the price makers are the merchants/distributors. As a result, the commodity prices soaring, but the ratio of the largest economy didn't reach the farmers.[8] *Third*, economic growth is sustained by non-tradable sectors which its import content is high and low labor absorption.[9]

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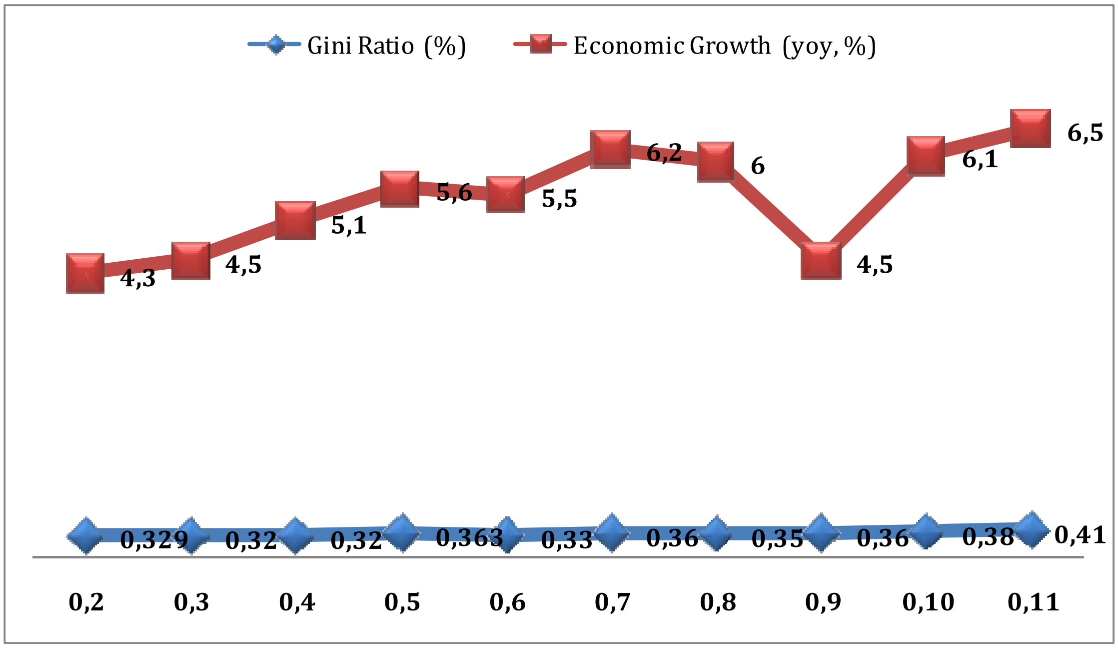
[8] The latest data from BPS proclaims the poverty rate in 2010 falls slightly to 13.33% (in 2009 reached 14.15%). That way, the number of poor people in 2010 reached 31.02 million inhabitants. However, although the percentage of poverty declined, but the percentage of the rural poor actually increased (from 63.35% in 2009 to 64.23% in 2010). This fact is a convincing confirmation that the (economic) development has been a tendency to marginalize the rural areas, especially those who work in the agricultural sector. See Ahmad Erani Yustika, *Kemiskinan dan Dualisme Ekonomi*, Jawa Pos, July 13 2010

[9] The manufacturing sector in Indonesia is still dependent on imported raw materials that high, stretching by 10.9% (paper industry and paper products) to 63.7% (telecommunications equipment industry). Even for the household appliances industry

The result, imports continue to grow and informal sector increasingly bloated (as a reservoir of labor that cannot enter into the formal sector). *Fourth*, the marginalization of traditional economic actors and small scale due to not compete along with the big economic players in the trade sector.[10] *Fifth*, the accumulation of a series of economic reform policies that makes income inequality increases along with a high rate of economic growth (as seen in Graph 1, the Gini Ratio increased to 0.41 in 2011).[11] Five implications of this are the "cost of economic reform" that must be borne by the society.

Graph 1: Indonesia Economic Growth and Gini Ratio 2002-2011



Source: Adapted from BPS (Indonesia Statistical Bureau), 2011

The Fragility of Macro Institutions

In addition to arguments on choices and wrong sequence of economic reform policies, problems of economic reforms that result in suboptimal performance also caused by a lack of institutional, or more precisely no institutional reform strategy.[12] In this perspective, economic reform policies require more detailed institutional, that in the absence of a solid institutional the entire policies designed would stop working in the middle of road. At this point, institutional reform is an "enabling environment" that makes the policy reforms can run as expected. At least there are three aspects of institutional reforms at the macro level (institutional environment) that are less touched when the government running the economic reform policies. The three aspects of institutional are administrative reform institutional, legal system reform, and political reform [Chowdhury, 1999:389]. One of the spirit of economic reforms is to provide a decent place for market to carry out the mission of accelerating economic activity on the basis of efficiency.

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and office were still dependent on imported raw materials by 56.7%. This is what makes some value-added manufacturing commodity fled abroad. See Mohamad Ikhsan Mojo, *Proyeksi Ekonomi 2010*, paper presented at the seminar INDEF Economic Outlook 2010, Jakarta, January 25, 2010, unpublished

[10] AC Nielsen's research in 2007 showed growth in traditional markets nationally by minus 8.1 percent, while the growth rate of modern market reached 37 percent nationally. See Harian Ekonomi Neraca, *Pemda Harus Kendalikan Pertumbuhan Ritel Modern*, September 3, 2010

[11] Gini ratio is in the range 0-1, where 0 means perfect equality and 1 means perfect inequality. Nonetheless, the data Indonesia Gini ratio is not too bad compared to Brazil 0.57 (2005), Malaysia 0.46 (2002), the Philippines 0.46 (2006), India 0.37 (2004) or China (2007). See Suahazil Nazara, *op. cit*., p. 8

[12] Institutional reform within the most extensive scope is interpreted as the changes that emphasize state-society relation, central-local affiliation, and the bond of party-state. See Scott Fritzen, Growth, Inequality and the Future Poverty Reduction in Vietnam, *Journal of Asian Economics*, Vol. 13, 2002: 635-657

The most serious implication of the spirit is certainly not to eliminate the role of government, but instead make the right choice of intervention with a more limited scope. In a simple language, economic reforms require a strong government but with a limited scope of coverage (strong but limited government). Limited scope meant the government only enters the area where the market cannot work or failure (market failure). In other words, it is not minimal state role, but requires a capable state in order to make the market-oriented policy reforms can be run (Ahrens, 2000:84). This is certainly contrary to the practice run before the economic reform in Indonesia, where the role of government went into almost each corner of economic activity, but with inadequate capacity of government (bureaucracy). Therefore, precisely on the momentum of economic reform the administrative capacity and bureaucracy competence become very important that it should not be neglected.[13]

Table 1: Major Problems of State Competitiveness 2011-2012

	Indonesia	Malaysia	Singapore	Thailand	Philippines	China
Corruption	15,4	9,6	0,3	14,5	24,4	8,5
Inefficient government bureaucracy	14,3	12,9	2,4	11,7	18,3	10,9
Inadequate supply of infrastructure	9,5	6,4	6,1	5,3	16,5	7,8
Policy instability	7,4	8,3	0,7	12,9	7,9	9,9
Access to financing	7,2	10,6	6,3	3,1	2,2	11,5
Inadequately educated workforce	6,3	8,7	15	8,3	2,5	6,6
Poor work ethic in national labor force	6,2	7	8,1	5,5	1,9	6,1
Government instability/coups	6,1	2,9	0,7	15,2	1,9	2,9
Inflation	6,1	5,8	29,1	5,1	2	11,6
Tax regulations	6	2,9	3,7	2,8	5,6	6,4
Tax rates	4,2	4	7	5,6	5,7	6,9
Restrictive labor regulations	3,6	10,4	16,8	1,2	4,6	4,5
Crime and theft	2,7	4,1	0,2	2	5,6	0,5
Poor public health	2,5	0,9	0,7	0	0,5	1,8
Foreign currency regulations	2,3	5,5	2,8	6,8	0,5	3,8

Notes: The blue color shows the biggest problem
Source: Adapted from WEF, 2011

The problem, the aspect of administrative-bureaucracy reform is hardly even touched in the design of economic reform in Indonesia. The report launched by the World Economic Forum (2011) clearly reveals the cause of the low economic competitiveness in Indonesia is caused by bureaucratic inefficiency. In this aspect, Indonesia lagged far behind the neighboring countries (like Malaysia, Thailand, China, and Singapore). Indonesia is only slightly better than the Philippines in this aspect. In fact, if viewed on other aspects, such as policy instability, access to financing, and inflation; Indonesia's position is able to compete with these countries (Table 1). This then makes the procedure and cost of starting a business in Indonesia to be inefficient (though it has improved in recent years). Currently the length of starting a business in Indonesia in 2011 is still 47 days (only better than Cambodia and East Timor) and the cost of starting a business reaches 22.3% of income per capita (only cheaper than Cambodia and the Philippines) [Table 2].[14] Thus, vibrant economic reform policies of deregulation in a certain degree it is correct, but because it is not supported by established administrative institutions that lead the policy cannot run (effectively).

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[13] A study in China shows that the quality of a good government is a condition for the presence of FDI (Foreign Direct Investment). Here, an established institutional also requires quality of good governance, which means it requires the presence of politicians and bureaucrats who are highly qualified. See Joseph P.H. Fan *et. al*. Institutions and Foreign Direct Investment: China versus the Rest of the World, *World Development*, Vol. 37, No. 4, 2009, p. 855

[14] The latest report of the World Economic Forum (2011) shows that Indonesia's competitiveness ranking declined quite dramatically from the original ranking 44 (2010) to 46 (2011) and still lagged behind Malaysia (rank 26), Brunei Darussalam (rank 28), and Thailand (rank 38). Some of the pillars that make Indonesia's competitiveness is lagging behind other countries because of institutional problems, infrastructure, and education. While the pillars which are considered pretty good in boosting the competitiveness of Indonesia are the macroeconomic environment, business development, and market size. In the meantime, which are considered the most problematic factors of doing business in Indonesia are still dominated by bureaucratic inefficiency and corruption. See Klaus Schwab (ed.), *The Global Competitiveness Report 2010-2011*, World Economic Forum, Switzerland, 2010, p. 184-185

Table 2: Cost of Starting a Business Indicators in Several Countries 2011

	Number of procedures to start a business	Number of days to start a business	Cost (% of income per capita)	Minimum capital (% of income per capita)
Singapore	3	3	0,7	0
Thailand	7	32	5,6	0
Indonesia	9	47	22,3	53,1
Cambodia	9	85	128,3	37
Malaysia	9	17	17,5	0
Timor-Leste	10	83	18,4	921,3
Vietnam	9	44	12,1	0
Philippines	15	38	30,3	6
OECD average	5,6	13,8	5,3	15,3
East Asia & Pacific average	7,8	39	27,1	50,6

Source: World Bank, 2011

Subsequently, the subject matter in an important economic activity is the clarity of property rights and respect for the rule of law (including its enforcement) as fundamental factors that determine the macroeconomic stability, capital market development, business sector development, and investment in innovation (Fan *et. al*., 2009:853). As mentioned earlier, market failure is a necessity in a market-based economy. Outside externalities factors, public goods, and monopoly/oligopoly practices, in the neoclassical economics view market failure often occurs due to unclear property rights (Caporaso and Levine, 1993:92). If the ownership rights over resources provided to the private economy (apart from the controversy behind it), then it will be the most important source for the emergence of production and economic creativity. Clarity of property rights also makes transactions easier to do for each economic actor has a certainty about the status of the goods/services; vice versa. Furthermore, the property rights are guaranteed through a strong legal system to prevent the emergence of economic actors to cheat, such as theft, plagiarism, piracy, and others.

At this point, investment that occurs in a country is not just a function of interest rates, economic expectations, availability of infrastructure, or credit supply. In the institutional tradition, investment is also related to how far the government (through its legal system) be capable of protecting investors from practices of copyright theft, plagiarism, piracy, and so forth (Nelson, 2008:6). In Indonesia, this is where the problem arises, namely the inability of legal system to protect investors from deviant behavior (opportunism) of other economic actors. Theft of copyright, plagiarism, and piracy are a commonplace in everyday economic activity, while the legal system could not give a penalty against those who act deviant behavior. By implication, the economic incentives to invest are reduced.[15] This practice occurs in almost all economic sectors so that in macro causes the credit ratio towards Indonesia's GDP is very low compared to other countries. The data shows that the credit ratio towards Indonesia's GDP is only about 26.5%, left behind Thailand (88.4%), Malaysia (116.1%), Singapore (112.8%), and South Korea (93.2%) [Bank Indonesia, 2010]. Thus, although the Indonesian government managed to conduct macroeconomic stability, but due to porous ownership rights security leads to decreasing investment incentives (in addition to other reasons, such as infrastructure limitations).

Finally, homework is considered ended when the political reforms have been implemented. The true meaning of political reform is not just a procedure to adopt the essential elements of democracy, such as scheduled elections, the existence of parliamentary institutions, and the institutionalization of media for expression.

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[15] A study conducted by PERC (Political and Economic Risk Consultancy) in 2010 mentions that Indonesia has the worst record in protecting intellectual property rights in Asia (ranked last out of the 12 Asian countries surveyed). Indonesia's score reached 8.5 (10 is the worst score in protecting intellectual property rights). More fully, Singapore leads the list with a score of 1.5, followed by Japan (2.1), Hong Kong (2.8), Taiwan (3.8) and South Korea (4.1). At the other end of the poor scale, second worst is Vietnam (8.4), China (7.9), Philippines (6.84), India (6.5), Thailand (6.17), and Malaysia (5.8). See Media Indonesia, *Pembajakan di Indonesia Tertinggi di Asia,* 25 Agustus 2010

More importantly, democracy as an output of political reform has provided a way for the traffic of interest transactions to be transparent and accountable. Here assumed if economic activity is deregulated and political system be democratic, the patronage between politicians and bureaucrats can be limited in the economic system that is driven by market (market-driven economic system). In fact, all that can happen only if democratic political system is equipped with well-defined rules and norms so the system can accommodate the political aspirations of the people (Chowdhury, 1999:398). Conversely, if the democratic political system is not supported by detailed rules, then the economic reform agenda potentially corrupted by political rent-seekers.

If the postulates were brought to the political context in Indonesia, then the reality will be found below. Programs or development projects placed in a safe state budget (APBN/APBD) partially divisible to manager/state officials or their relatives. More dramatically, the construction projects ware awarded to political fund managers who previously sponsored the award of one of the election contestants who later became the leader (local/central). The implication, the project couldn't be executed according to term of reference since the bureaucracy has lost its most important knot in the assessment of process of a project: monitoring and evaluation. So, if the economic infrastructure is yet always in a bad condition that disrupts the investment climate, the reason is actually not because the government did not have the funds. What actually happens in the field is some (most) budget were cut and divided up to the rent-seekers, which then left a little for the actual construction project. This is a part of the macro institutional fragility, political reform institutional in particular, which run in Indonesia during the last decade.

The Weakness of Micro Institutions

Outside the agenda, failure creates macro institutional changes that become an enabling environment for the journey of economic reforms, institutional problems also arise at the micro level (institutional arrangement). Magnitude of economic reforms which aim is to create macroeconomic stability, such as economic growth, exchange rates, inflation, interest rates, balance of payments, fiscal discipline, and others require a detailed institutional support to the achievement of macroeconomic stability walking in the right corridor. In some cases, macroeconomic stability that is achieved in a country may occur in the middle of fundamental economic problems, such as poverty, income inequality, and unemployment. This can take place because of the economic output that can be achieved through two ways, namely the policy and the institutional. Policy functions show the direction/target/economic objectives (e.g. economic growth), while the institutional designs procedures for how it is to be achieved. Thus, despite the economic policies that produced by two countries are the same, but economic output may vary due to differences in institutions that used to run the policy.

Table 3: Poverty in Indonesia 2010-2011

Region/Year	Poverty Line (Rp/Capita/Month)			Number of Poor (Million)	Percentage of Poor People
	Foods	Non-foods	Total		
Urban					
March 2010	163,077	69,912	232,989	11,10	9.87
March 2011	177,342	75,674	253,016	11,05	9.23
Change (yoy,%)	8.75	8.24	8.6	0,05	0,64
Rural					
March 2010	148,939	43,415	192,354	19,93	16.56
March 2011	165,211	48,184	213,395	18,97	15.72
Change (yoy,%)	10.93	10.98	10.94	0,96	0.84
Urban + Rural					
March 2010	155,615	56,111	211,726	31,02	13.33
March 2011	171,834	61,906	233,740	30,02	12.49
Change (yoy,%)	10.42	10.33	10.40	1,00	0.84

Source: Adapted from data SUSENAS Panel March 2010 and March 2011

Here will be reviewed briefly, why the economic reforms in Indonesia produce a relatively good macroeconomic stability but leave a residue that is no less critical, namely poverty, income inequality, and unemployment.

First, although the fund and a handful of economic policies have been produced to address the poverty problem, but the decrease in the number of poor people does not show an impressive data (Table 3).[16] In 1990, the poverty percentage is by 15.1% or the equivalent of 27.2 million inhabitants at the time. In 2011, the percentage of poor population is by 12.49% (30.02 million inhabitants). Thus, during the last 21 years, say, there is no progress in overcoming poverty (in part due to population growth). This can occur for government is absent to formulate direct policies that link institutions with poverty reduction strategies.[17]

Second, at the beginning has been declared that stable economic growth in recent years becomes a fertile ground for an increase in income inequality. In an institutional perspective this can be explained in two ways: (i) inflation cannot be fully controlled by the government and central bank, which unfortunately is very harmful for the poor because most of these coming from the rising of food prices[18] (most of the poor income are spent on food consumption). Government cannot cope with food inflation since agricultural production and distribution institutions are not managed; (ii) there is a tendency of the gap between inflation and (the province) minimum wage is getting thinner. A few years ago (e.g. 2001), the percentage of the increase of minimum wage was much greater than inflation, but in recent years (e.g. 2008) the proportion of rising inflation is almost equal to the minimum wage increasing (BPS, 2009). Why does this happen? The answer is because there is no institution in the form of a formal statute that created by government to regulate the proportion of an increase of minimum wage; and (iii) financial liberalization simply becomes an instrument of playing money from one pocket to another pocket (the capital owners) without having an impact on real economic activity (investment). The economy is growing (financial sector as the trigger), yet continues to spin on a handful of capital/money holders. Once again, financial liberalization is not offset by institutions which handling how these funds should be managed and utilized for the welfare of the community.

Third, open unemployment systematically show a decline (though very slowly), but the number of workers classified as underemployed (working less than 35 hours per week) is still very large, estimated at 30 million inhabitants. More disappointing, the number of workers entering the informal sector continues to grow so that now reaches nearly 70% of the total workforce (Indef, 20010). This phenomenon occurs because of the following factors: incentive design that does not work in the agricultural sector, high cost of business license, rent-seeking behavior in the promotion of economic sector, access to capital that does not run optimally, and the absence of legal protection for the informal sector. The whole cause of it is the institutional problems that are not prepared seriously by the government, giving rise to complications of economic problem, particularly unemployment.

The analysis above clearly indicates that one of the most important tasks for government onwards in rescuing economic reform is to design more detailed micro institutions therefore the principal economic problems (poverty, income inequality, and unemployment in particular) can be overcome. Table 5 provides guidance on institutional work that must be formulated and implemented seriously from now on. At the macro level, the institutional of administrative system, legal, and politics become the focus that must not be forgotten.

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[16] In 2005 the government budgeted Rp 23 trillion (App. US$ 2.5 billion) for poverty reduction. This budget rose nearly tripled to Rp 66.2 trillion in 2009. During the period 2005-2009 the total funds that have been rolled out to overcome the poverty amounted to Rp 245,2 trillion. Yet, the budget could only reduce the poverty rate of less than 2 percent (actually 1.8 percent) of 16.0 percent (2005) to 14.2 percent (2009). This means that the effectiveness of budget utilization for poverty reduction is very low since it could only reduce the poverty rate of less than 2 percent within 5 years

[17] In the period 1980-1993 Indonesia (along with Malaysia) entered as the best countries that could combine economic growth and equitable distribution of income at the same time. In contrast, Russia (1980-1993) is the worst case due to low economic growth and high income inequality. China (1985-1993) and Thailand (1981-1992) attain high economic growth, yet bad in income distribution. Meanwhile, income distribution in Sri Lanka (1981-1990) is good, yet low in the economic growth. See Scott Fritzen, Growth, Inequality and the Future of Poverty Reduction in Vietnam, *Journal of Asian Economics*, Vol. 13, 2002, p. 651

[18] Jut for example, rice prices increased an average of 18.40% per year and the price of cooking oil without brand rose 22.77% per year (period 2004-2008). See Department of Commerce, *Statistik Perdagangan*, October 2008. The increase is much higher than the average inflation of "only" about 9.5% in the period. Thus, the real inflation that must be borne by the poor is actually equivalent to the inflation of food, which is about 18%.

Meanwhile, at the micro level, institutions that are directly related to the reduction of poverty, income inequality, and unemployment should be formulated in detail, such as relation statute amongst economic actors, turning on the assets of the poor, promotion of small and medium enterprises, food price controls, minimum wage rules, simplifying business licenses, protection for informal sector actors, and so forth. Subsequently, macro and micro institutional itself are not enough, but still must be supported by institutional social support, in a form of social security and income transfer to ensure that each individual can live decent lives.

Table s: The Required Institutional Reforms

Institutional Level	Details of Rules of Play	Expected Results
Macro Institutions		
Administrative reform	- Meritocracy system - Decent remuneration - Reward and punishment application - Enhancement of bureaucracy competence	Bureaucratic and administrative system that capable of running economic reform policies effectively
Legal reform	- Independence reinforcement - Decent remuneration - Consistent enforcement of rules - Property rights protection	Legal system that can be accessible to all communities, there is assurance, fair, consistent, and quick.
Political reform	- Checks and balances reinforcement - Transparency of decision-making process - Circulation and distribution of power	The political system that works to meet the needs of the people, not run because the motives of personal gain (rent-seeking)
Micro Institutions		
Institutions of poverty reduction	- Relation statute amongst economic actors - Trimming the dominance of the local merchants position - Regulation of land additions - Reviving the late assets - Reinforcement of cooperation and small and medium enterprises	Rapid poverty reduction and provide adequate permanent business opportunities
Institutions of income inequality reduction	- Food price control - Statute of decent minimum wage - Adjustment of productive assets ownership - Credit quota to the agricultural sector and IBT (out of Java)	Equitable distribution of income, over individuals, sectors, as well as interregional.
Institutions of unemployment reduction	- Increasing incentives in the agricultural sector, including overhauling distribution institutional - Simplifying and reducing the cost of business license - Improvement of access to capital - Protection of informal sector	Unemployment reduction, particularly due to wrong policy application, so that each individual can maximize their individual capabilities
Social Institutions		
Basic needs guarantee	- Social security (housing, unemployment, exc.) - Scheme of education and health	Ensuring everyone could meet the needs of decent living
Income transfers	- Progressive tax and focused subsidies - Employment opportunities assurance	Ensuring that everyone could involve to market (permanent work)

Epilogue

Economic crisis in 1997/1998 must be recognized as a vital starting point that changed the character of the national economy quite drastically. Before the economic crisis, Indonesia economy characteristic was described by means of excessive state role in the economy, concentrated business structure (monopoly/oligopoly), centralization of economic management, fiscal and monetary policy which were less credible, unhealthy political-business patronage. Despite the fact that the economic crisis in 1997/1998 did not depart from these problems, but as realized the economic characteristic led the economic crisis be deeper and difficult to overcome. In the end, the economic crisis at that time turned out into political crisis (leadership) as the precursor of economic and political reforms. Here, political reform becomes an opening door to more intensive economic reforms.

The economic reforms that were chosen in Indonesia are quite different from the pathway of economic reforms in other Asian countries. Indonesia embarked on macro level, preceded economic reforms at the micro level. In general, Indonesia is a country that has taken the choice of economic reforms on a large scale, amongst which is marked by the liberalization of financial and trade sector, economic decentralization, running the system of market economy (including state enterprises privatization projects), fiscal discipline (maintaining fiscal deficit) and monetary (including central bank independence), and introduction to fair business competition regulations. The harvests of economic reforms, need to be recognized, in some part generate good economic performance, macroeconomic stability in particular. Nevertheless, beyond the macroeconomic stability, the economic reforms just create a range of worrying issues for the future of national economy, such as rising income inequality, stagnant poverty, and a slow decline in unemployment.

The cause of deterioration part of economic performs not only can be seen through the selection of economic reform policies, but also weaknesses in the design of qualified institutions. In a large frame, the unqualified institutions are reflected on the failures of government creating institutional environment in the form of administrative institutional reform, legal system (law), and the political system (democracy). All three are necessary condition thereby the economic reform policies can run in the field. In the following, macro institutional (institutional environment) is not sufficient, because it still needs more micro institutional (institutional arrangements) to support economic reform policies. Institutions at micro level in the case of income inequality are the details of minimum wage regulations, food pricing policy, and resources utilization in the financial sector. Institutions that related to poverty problems are the rules of relation statute amongst economic actors, reviving up the late economic assets, a selective international trade. Finally, in terms of unemployment institutions that must be prepared are incentives design which does not work in the agricultural sector, high cost of business license, rent-seeking behavior in economic sector promotion, access to capital that does not run optimally, and the absence of legal protection towards informal sector. Unfortunately, these micro institutions are absent in the implementation of economic reform policies in Indonesia. Last but not least, social institutions must be presented to ensure that in the reform process there is no community groups that run over the wheels of economic changes, that is with social security instruments and income transfers.

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