

GOVERNANCE IN INDONESIA: SOME COMMENTS

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Governance is often a difficult process. Proper governance--whether of a nation or of a unit such as a government department or company or school--ideally involves, first, the formulation of an overall strategy of operations, followed by the translation of the broad strategy into specific policies and decisions, and then the implementation of the decisions through selected activities. This process, even when things go smoothly, is often difficult. But to complicate things, in practice the best-laid plans of mice and men often go awry. Leaders frequently find it hard to muster support for their plans, and circumstances are often change in startling ways as well when financial or physical hurricanes or tsunamis strike a nation out of the blue. So often, the new government program that seemed so well-suited to the outlook in January can be in trouble by February and in need of substantial revision by March. Thus another part of the art of effective governance is the ability to manage with an eye to both the long-term and the short-term at the same time.

This is a paper with some thoughts about the governance of Indonesia. The topic of the governance of a nation of over 220 million people, the fourth largest in the world, is one of great complexity. The topic is vast. However the aim of this paper is modest. The aim is merely to first, outline just a few of the main strategic issues of governance in Indonesia, and second, to outline some options for change.

Definition of Governance

Broad definitions of governance are often rather vague (Box 1). There is a very considerable literature that discusses how, precisely, the concept of governance might be defined¹; for the purposes of this paper this literature may be summarised as emphasising the following:

- The processes by which governments are chosen, monitored, and changed.
- The systems of interaction between the administration, the legislature, and the judiciary.
- The ability of government to create and to implement public policy.
- The mechanisms by which citizens and groups define their interests and interact with institutions of authority and with each other.

Considering these issues in the context of governance in Indonesia, two comments may be made. First, a good deal of governance is about the exercise of various forms of power. There are different types of power--ideological, political, legal, military, economic, administrative, and so on--and governments everywhere frequently use various combinations of power to govern.² It is important that economists, when considering issues of governance, bear in mind that many senior government leaders see economic policy tools as part of the broader spectrum of levers of power which they

¹ A useful summary is in a recent SMERU Working Paper by Sudarno, Asep and Arifianto (2004).

² Galbraith's essay on power (1983) is a useful outline of issues for economists.

can draw upon at any time to achieve their goals. Just as one famous brief definition of economics is that economics is about "who produces what, and for whom", so a brief definition of governance might be "who controls what, and for whom".

BOX 1: SOME DEFINITIONS OF GOVERNANCE

"GOVERNANCE is the exercise of political, economic and administrative authority to manage a nation's affairs. It is the complex mechanisms, processes and institutions through which citizens and groups articulate their interests, exercise their legal rights and obligations, and mediate their differences." (UNDP)

"GOVERNANCE is the manner in which power is exercised in the management of a country's social and economic resources for development. Governance means the way those with power use that power." (ADB)

GOVERNANCE is "... the traditions and institutions by which authority in a country is exercised for the common good. This includes (i) the process by which those in authority are selected, monitored and replaced, (ii) the capacity of the government to effectively manage its resources and implement sound policies, and (iii) the respect of citizens and the state for the institutions that govern economic and social interactions among them. " (World Bank)

Second, for the purposes of discussing governance in Indonesia, it is useful to distinguish between issues of governance at the macro and micro level.

- Matters which might be classified at the macro level include such things as constitutional reform; the overall role of government itself (size and resources); the relationship between the key national institutions of the administration, the legislature, the judiciary, and the military; and the manner in which the political market operates.
- Micro issues of governance can be taken to include issues in many sectors of the nation including at the regional and unit level: government departments, state owned enterprises (SOEs), commercial firms, education and health institutions, cooperatives, organisations active in civil society affairs (such as the media, think tanks, and non-government organisations), and informal institutions of governance which operate in the large informal sector across Indonesia.

Perhaps the most striking thing, looking over these incomplete lists, is how broad the topic of governance really is. This paper will survey just a few issues of governance in Indonesia.

Macro Issues of Governance

At the broadest levels of governance, 60 years after Independence many major issues remain unsettled. Of course, every country has issues that are seen as matters of high importance on the national agenda. However it is hard to avoid the impression that Indonesia has an especially daunting array of key issues which, one way or another, have not been properly addressed since Independence in 1945. Indeed, many of these matters are arguably "unfinished business" arising from turmoil of the hurried transition to Independence in 1945. For various reasons, usually reflecting the immediate priorities of the day in the 1950s, the 1960s, the 1970s, and so on, it never seemed quite the right time to address these issues in an effective way.

What are these issues? The list is quite long so this paper will focus on several selected topics:

- The role of the state, and the government in Indonesia, vis-à-vis the people.
- The capacity of (ie., the resources available to) the government in Indonesia.
- The separation of powers between the administration, legislature, and judiciary, and the way that the constituent parts of these three arms of government operate internally.
- The way the political system operates.
- The state and markets in Indonesia.
- The role of selected institutions in the Indonesian intellectual community in contributing to governance in Indonesia.

It is true that issues of this kind are debated at length over many decades in many countries. Nevertheless, bearing in mind that it is now almost 60 years since Independence, the scale of unfinished business that Indonesia still needs to deal with seems very large. And while there is so much uncertainty about so many key issues, it is almost inevitable that many of the rules of the game concerning public policy issues in Indonesia will remain unclear. The result is that the scope for disagreements between powerful actors and institutions remains very wide.

How important are these matters? The answer is that while doubtless day to day life continues despite the fact that issues of this kind remain unsettled, they are very important indeed. It is very difficult -- perhaps impossible -- to have satisfactory processes of governance at other levels across the nation when so many key high level issues remain unsettled, and when the rules of the game in so many areas of political, administrative, legal, and economic and commercial life are vague. It is notable that the comment that "we don't have the rule of law in this country" is often heard in Indonesia, and that many Indonesians comment about the *kacau* (confused) state of Indonesian society. It would seem clear that it will be necessary to make considerable progress on some of the main questions of governance in Indonesia before more orderly processes of public life can be firmly established.

The State and the People

In every nation a social contract of some form exists between the leaders of government and the populace. What is the nature of this social contract in Indonesia? How do the workings of this contract interact with the broad processes of governance? And are the current perceptions of this social contract compatible with the efficient governance of Indonesia?

Indonesia is a nation born through revolution. Following the revolution the first, fiery, President of the Republic, Soekarno, frequently drew on the spirit of the revolution to bolster his legitimacy and power for two decades up to the mid-1960s. The second President governed for the next three decades in a very different way.³ As President, Soeharto turned away from revolutionary rhetoric and chose, instead, to draw upon less flamboyant but highly effective Javanese symbols of princely authority. At the same time Soeharto, concerned to promote *pembangunan* (development), fostered the institutions of a centralist and regulatory 'developmental state' that allowed but limited space for institutions outside the orbit of strong Presidential influence to function effectively. In the relatively brief seven years since the end of the Soeharto presidency in May 1998, four Presidents with markedly different styles and priorities have held the leadership of the Indonesian state. The experience gained during these four periods of presidency has, of course, greatly enriched the institution of the office of the president in Indonesia, but it is still rather early to be able to evaluate the position of the institution of the presidency in Indonesia in the post-Soeharto period.

Against this background, and particularly bearing in mind the continuing influence of the legacies from the lengthy Sukarno and Soeharto presidential periods (Booth 2005), it is perhaps not surprising that many commentators argue that the social contract between government leaders and the people in Indonesia has often been strongly influenced by patron-client relationships. Furthermore, and an important matter in the current context, since Independence many of the strongest patrons in Indonesia have derived their power and influence through access to state-controlled resources (one thinks of Sukarno and the nationalized Dutch enterprises in the late 1950s and Soeharto and the oil booms of the 1970s). Thus the widespread expectation has arisen, and has been encouraged by many government leaders in their roles as patrons, that the state in Indonesia will play a paternal role in which an important aim will be to provide protection of various kinds for the *wong cilik* (small people) across Indonesia and in which patrons will dispense state resources in a beneficent way to the people. The wording of the original 1945 Constitution, which emphasized such things as the duty of government to provide various services and resources to the people as well as the frequently-quoted Article 33 with its collective overtones, reinforced high expectations of this type of social contract in post-Independent Indonesia.⁴

³ Thee (2003) provides an excellent overview with an emphasis on economic issues.

⁴ The elaboration to the Constitution provided by the Department of Information at the time explained that Article 33 "is laid down on the basis of economic democracy, production for all by all, under the leadership or control of the members of the community. It is prosperity of the community which is stressed, not prosperity of the individual. For that reason, the economy is organized as a common effort, based on ways of working that accord with the family principle. The co-operative is the form of enterprise in harmony with this. ... Only enterprises which do not affect the life of most people may be in the hands of individuals."

Public policy debate about such matters in Indonesia has naturally evolved considerably since 1945.⁵ Nevertheless, the early post-Independence expectations that a strong government would provide protection and welfare for the people has continued to influence views about the appropriate role for government in Indonesia up to the present day. It will be suggested below that it might be useful, as a step towards better national governance, for there now be renewed consideration about this issue in Indonesia.⁶

Resources Available To Government

In discussing these matters in a realistic way a central consideration must be the financial capacity of the state. It is a notable feature of recent Indonesian economic history that the financial resources available to the central government have varied dramatically during the period since Independence.

During the Sukarno presidency careful economic management was neglected. By the mid-1960s government spending had collapsed to less than 10% of GDP (Hill 1994). The financial capacity of the central government was so weak that it was very difficult for the central government to support even the quite basic functions of the state. For a time during the early years of the new Soeharto presidency the government sector continued to operate under improving but still very restricted budgetary constraints. Official agencies continued to find it difficult to provide even minimum acceptable levels of service to the public. But then the situation changed dramatically. In 1974, windfall gains from the first oil boom permitted rapid increases in real government spending on public services. Further increases were possible following the second oil boom of the late 1970s. As a result of the oil booms, combined with useful financial assistance from the international donor community, government expenditures as a share of GDP roughly doubled during this period rising from about 12% in 1970 to a peak of almost 25% a decade later.⁷

However the early 1980s marked the peak of the government spending boom (Booth 2005). Two longer term trends, one on the revenue side of the budget and one on the expenditure side, were beginning to erode the financial capacity of the government to deliver public services and government investment. On the revenue side oil receipts began to decline as domestic consumption steadily rose and increasingly ate into the surplus available for exports. Today the situation has been reached where Indonesia is no longer a net oil exporter and, for the time being at least, from the budgetary point of view the Indonesian oil boom is over. On the expenditure side, difficulties were emerging as well. Just as the oil revenues began to decline, debt service obligations began to rise quite markedly eating into the resources available to support public services and investment. And then, as is well known, debt service obligations expanded again dramatically in the wake of the 1997-98 financial crisis.

These trends, aptly described by Hill (1994) as a 'scissors effect', have increasingly limited the financial capacity of the Indonesian central government in recent years to deliver public services such as education and health and government investment in

⁵ The debate about *ekonomi Pancasila*, for example, discussed relevant issues. See Mubyarto (1984) and comments by Boediono (2005).

⁶ Issues of rethinking the role of the state were discussed in detail in the 1997 World Development Review (World Bank 1997).

⁷ For useful graphs showing the changes between 1966 and 1991 see Hill (1994) p. 94.

sectors such as power, water, and transport. Other recent developments, such as the decentralisation of functions to regional governments, the financial impact of the tsunami disaster of December 2004, and the rapid increases in the cost of fuel subsidies, have further exacerbated the situation.

The net result of these factors is that in mid 2005 the central government finds itself in straightened financial circumstances with little room to manoeuvre (Table 1). On one hand, it is clear that there is an increasingly urgent need to increase spending on both public services and public infrastructure. On the other hand, fiscal constraints severely limit government options.

TABLE 1: GOVERNMENT SPENDING IN SELECTED COUNTRIES, 2002

| Country | Govt expenditure | |
|----------------|------------------|---------------|
| | Total, \$ bn | Per capita \$ |
| United Kingdom | 864 | 15,700 |
| Japan | 1,730 | 13,600 |
| United States | 3,730 | 12,860 |
| Australia | 270 | 10,100 |
| Indonesia | 38 | 170 |

Source: OECD statistics and ADB Key Indicators

One of the implications of this situation is that for the present, there are very few domestic public resources available to support spending on programs to improve good governance in Indonesia. A second implication, and one that is germane to discussions of governance in Indonesia, is that the state needs to be streamlined in a way more consistent with modern approaches to governance and public administration. As a move in this direction that recognises the severe constraints on resources in developing countries in Asia, some observers have argued that the pragmatic concept of "good enough governance" is perhaps the yardstick that should be used to approach governance reform in the region (Grindle 2004; Westcott 2005).

Three Arms of Government

It is common in discussions about public policy to distinguish between the three arms of government of the administration, the legislature, and the judiciary. To be sure, disputes over matters of influence and power between these arms of government are common in many countries, and indeed the precise balance of authority between them tends to ebb and wane depending on many factors including the political mood of the day, the financial strength of different institutions, personalities, issues at stake, and so on.

Nevertheless, in any discussion of governance it is useful to distinguish between the situation in countries where, on one hand, relationships between these main arms of government are relatively well-defined and countries where, on the other hand, relationships are in a state of considerable flux. Many OECD countries fall into the former group while many developing countries, including Indonesia, would seem to fall into the latter group.

It seems clear that the processes of institutional change required in many developing countries to foster clearer and more generally-accepted relationships between the main arms of government are likely to take considerable time. Rome was not built in a day, and in most of the OECD countries the process of establishing a reasonably stable and predictable balance of power between the main arms of government took centuries. It is inevitable that the process of institutional change is greatly influenced by the state of politics in any particular country. While effective political processes provide no guarantee that appropriate reforms will be implemented, at least the initial conditions for institutional change and improvement exist. But when political processes are less established and the rules of the game are less clear, as has been the case for much of the time since Independence in Indonesia, then it becomes much harder to design and to implement rules which establish clear and agreed relationships between the three arms of government.⁸

To complicate matters further, it is well known that other arms of government have often wielded considerable real power as well in Indonesia. For almost all of Indonesia's post-Independence history the military has played an important role across the nation in civilian and business as well as purely military affairs, and various SOEs (especially large SOEs such as Pertamina) have been seen as influential "states within a state".

Ultimately the extremely complex business of establishing acceptable and effective balances of power between these different arms of government is best managed through a well-functioning political process. Because political processes are so central both to issues concerning balances of power within government as well as to many other aspects of governance as well, some further consideration of the way political markets operate is useful.

Political Industry

It is important in the context of a discussion about governance to bear in mind that a country -- any country -- needs a good and effective political industry. There are advantages, too, in considering the political process as an "industry" because the traditional approach to industrial economics, with a focus on the structure-conduct-performance paradigm, provides a convenient framework to consider some key aspects of the relationship between political processes and governance.

⁸ The *Financial Times* (12 July 2005) recently editorialized about the balance of power between different parts of the political system in the Philippines under the heading of "A mess in Manila under Macapagal." "The current Philippine system is corrupt and ineffective. Presidents with good policies struggle to have them approved by self-serving members of Congress. The Supreme Court constantly interferes in politics when it should be interpreting the law. The army and the Catholic church also wield excessive influence."

Just as it is desirable that other industries work well, so it is desirable that the domestic political industry works well both operating in an effective way, and providing satisfactory outcomes. What does it mean to say that the political industry should "operate in an effective way"? One main thing needed is a balance between, on one hand, proper opportunities for civil society institutions to participate in decision-making and to reflect the interests of citizens, and on the other hand, a reliable stream of good decisions. However finding the balance between talk and action is sometimes difficult. If politicians and civil society organizations talk endlessly about national issues without reaching a decision (as, for example, delegations to the United Nations are often accused of doing) then it is unlikely that there will be good governance. Decisions, whether they are unpopular or not, are necessary to keep the processes of government moving along and to ensure that timely reforms are decided upon and implemented. Thus finding the right balance between talk and action is a key issue for good governance. Unfortunately, looking across the Asia-Pacific region, it seems that the political industry in many countries is finding it difficult to arrive at a good balance.⁹

Good and effective operations are not enough in themselves. We also need good outcomes. Thus the delivery of effective governance would seem to involve, perhaps, three things -- good decisions, that are well implemented, and which yield good outcomes. Decisions; implementation; and outcomes. Putting all of these things together is very difficult. And what we observe in many developing countries is that at the broadest level, the political processes -- that is, the political industry -- do not seem to be putting these things together well.

There is an important contrast here between the way the political industries operate in most rich countries and the way they operate in many poor countries. In most rich countries, broadly speaking, political industries operate in a satisfactory way. But broadly speaking, this is not true in many developing countries. This is surely an important phenomenon for the topic of governance. What can we say about this? Why is this so?

Political Markets

What are the key characteristics that it is useful to focus on when considering political activities as an industry? From an economic point of view, important industry variables are elements such as entrepreneurs, firms, strategies, revenue flows, and inputs and outputs, and industries are thought most likely to function well when there is "healthy competition".¹⁰ Considering these elements, it seems clear that one can consider the process of formal politics in most countries as being part of an industry. Political leaders such as George W. Bush, Tony Blair, and Junichiro Koizumi are certainly entrepreneurs par excellence. They take risks, play for high stakes, and they lead parties that are, effectively, large and well-known firms in the national political industry. There are strategies, outputs and revenue flows within the industry -- and as is well known, revenue and expenditure flows of various kinds (both formal and informal) are a key part

⁹ The detailed discussion of the characteristics of hard and soft states in Gunnar Myrdal's classic study, *Asian Drama*, remains an extremely useful framework within which to consider these issues (Myrdal 1968).

¹⁰ The adjective "healthy" is important, especially in the Indonesian context. There are many examples of sharply competitive behaviour in Indonesian markets (artificial and misleading labeling, adulteration of products, failure to maintain health and safety standards, and so on) which are not generally considered desirable.

of the political industry in most countries. And most voters in most rich countries would hope that there is healthy competition within the political industry, especially close to election time.

Furthermore, in practice, the political industry in most rich countries is relatively well regulated. As a general rule, in rich countries both the formal and informal rules of the political game are well known and are generally adhered to by most players. Of course, the existing rules are challenged from time to time but when this happens there is generally a process for settling disputes in an orderly way. An example of this process of dispute resolution occurred when the results of the presidential election were challenged in the United States in 2000. Although there was some controversy between the Republican and Democratic parties over the final results of the contest between candidates Bush and Gore, in the end the process of resolving differences was -- broadly speaking -- accepted across the political industry. Much of this is in sharp contrast to the situation in developing countries. In many developing countries local political markets are chaotic, often operating in an uncertain and rapidly evolving regulatory environment where the formal and informal rules are not especially well-known or understood by local actors in the industry.

Just as many agricultural and industrial and labor markets in developing countries are chaotic and in need of reform, it would seem that the political markets in many developing countries are also in need of reform. To illustrate this point, it is useful to consider changes that might be undertaken in three areas: competition arrangements, selection of the chief executives of the organizations (CEOs) in the industry, and rules of the game.

First, as noted above as far as competition arrangements in political markets are concerned, what seems to be needed is not just competition but healthy competition. One main problem with the competitive arrangements in political markets in many developing countries at present is that too often, there is either very little effective competition (Indonesia during the Soeharto era) -- or too much (Indonesia since the Soeharto era)! When there is too much competition -- when there are, say, more than 20 parties contesting national elections -- the process tends to become chaotic. In contrast, in quite a few Western countries, markets which are essentially duopolistic in nature (with two main parties, or at least two main sides to the political industry) seem to have worked quite well. In countries with a Westminster system such as the United Kingdom, Canada and Australia, the structure of having a formalized government and opposition has generally produced satisfactory outcomes. In the United States the two main parties, Republicans and Democrats, essentially dominate the formal political market in a duopoly. In these duopolistic markets there are often a number of small parties that serve to pose a potential threat to the dominance of the two largest parties. The smaller parties constantly try to improve their market share. If they are successful in this attempt (as seems to be occurring in the United Kingdom over time), the two main firms in the duopolistic market come under strong pressure to improve their performance.

Of course, a duopoly is not the only market structure that exists in political industries in rich countries. In some countries that are generally regarded as having effective government arrangements (the Netherlands is an example) there are a number of

parties. It is thus clear that a duopoly is not necessarily the best model to ensure that healthy competition exists.

A second area where, perhaps, reforms are needed in some developing countries is in the process by which the CEOs of the political firms are selected. This, really, is a very important process because it is these CEOs who often become the President or Prime Minister of the nation. If the CEOs are inexperienced at government, and if they cannot skillfully manage board meetings (often the Cabinet meetings of the nation), then the governance of a country is likely to suffer.

However, when we look across the developing world it seems clear that the processes for the selection of the CEOs of political firms are often poor. One thinks of President Estrada in the Philippines, for example, as a CEO who surely appeared unsuitable even before he took office. In contrast, in most (although certainly not all!) rich countries, the process of selecting CEOs for political firms is more rigorous. In the highly competitive Westminster parliamentary system it is unusual for a person to climb to the top and become Prime Minister without many years of experience and without being subjected to very close scrutiny in the national media over a long period. One way or another, it would seem that in many developing countries, the processes for the selection of CEOs in the political industry need to be improved.

A third area where improvement would be helpful is in defining and enforcing both the formal and informal rules of the game. In other words, there need to be reasonably clear regulatory rules for the political industry -- and the rules need to be enforced. This is very difficult, of course, when legal systems are weak but it is at least useful to consider the directions that reforms might take. Effective electoral commissions are needed to conduct free and fair elections, and to take action when there is abuse of the electoral process. The performance of Indonesian electoral institutions was tested in the 2004 elections and, given limited resources, the institutions were widely judged to have performed well. It also seems clear that it would be highly desirable to establish reasonable procedures for monitoring financial flows within political industries. Firms in the political industry should be required, just as firms are in other industries, to maintain audited internal accounts and publish proper annual financial reports.

In this context, it is worth noting that the current confusion that exists in pricing arrangements in the political industry in many developing countries does not seem conducive to good government. A more realistic approach to prices and salaries is needed. It is well known, for example, that the actual annual incomes that many parliamentarians in many countries have are far higher than their nominal parliamentary salaries. One reason for this -- not the only reason, but one reason -- is that the nominal official salaries are well below reasonable living standards for people in the political industry. It would be a step towards reality if it were recognized that trying to regulate (and suppress) nominal salaries in this way encourages the development, in effect, of political and administrative black markets. Just as it became widely realized during the 1970s that attempts to suppress the price mechanism in foreign exchange markets led to black markets for currencies, so it needs to be recognized that attempts to set incomes in political markets that are well below equilibrium prices encourage the growth of black markets in political activities.

State and Market

This discussion of the political market opens up the wider question of the role of the state in facilitating the operations of other markets in Indonesia as well.

This topic is a central one for governance in Indonesia for several reasons:

- Given the current constraints on the resources of the state it is inevitable that many transactions, including transactions often managed by the state in many other countries, will be conducted through markets.
- In fact, Indonesia is already a very highly market-oriented society with many markets operating in only loosely regulated ways -- indeed Indonesia is market-oriented to such a degree that many transactions occur through markets in ways which are of doubtful legality and which in any case are widely regarded as, in principle, unacceptable.
- Many markets in Indonesia work badly because both market failure and government failure is widespread.
- There is a need to consider the best role for the Indonesian state, including regulatory authorities, with the aim of improving competition policies and the working of markets in Indonesia.

Economic liberalization has been a key part of the national economic agenda in Indonesia since the mid 1980s when the Government began the practice of regularly announcing economic reform "packages". At the time, the international community was increasingly pressing the Indonesian Government to loosen economic controls. One central message from the Western donor community was that economic liberalisation was needed to spur development. Entrepreneurship, private sector, market forces, competition--these were the things that the international community urged the Indonesian government to promote. Later, in the 1990s when the conventional wisdom of the day was summarized in the Washington consensus (Box 2), similar policies continued to be urged upon Indonesia. And then came the great financial crisis of 1997-98 that brought huge damage to the Indonesian economy. This crisis was, arguably, caused by a combination of both market failure and government failure (Hayami 2003).

The fact is that the task of "getting markets to work" is often extremely difficult. This generalization appears to be true for many different types of markets in many different industries across Asia. Whether one is talking about factor markets, goods markets, or financial or foreign exchange markets, or political markets, the generalization appears to hold -- many markets across Asia, including in Indonesia, do not work very well. Both market failure and government failure is widespread across the region. Indeed, the task of "getting markets to work" is surely one of the major challenges for economic policy-makers during the next decade or so in developing countries in the Asia-Pacific region. In Indonesia, there is still a myriad of controls on domestic markets that both limit trade and create opportunities for evasion of various kinds. Thee, in commenting on "the pervasiveness of policy-generated barriers to domestic competition", has noted that "restrictions on domestic competition and trade were pervasive in the 1980s and the first half of the 1990s" in Indonesia. (Thee 2004).

BOX 2: THE WASHINGTON CONSENSUS: 10 PRINCIPLES

1. Fiscal discipline.
2. Concentration of public expenditure on public goods (including education, health, and infrastructure).
3. Tax reform towards broadening the tax base with moderate to marginal tax rates.
4. Interest rates to be determined and positive.
5. Competitive exchange rates.
6. Trade liberalisation.
7. Openness to foreign investment.
8. Privatization of state enterprises.
9. Deregulation or abolishment of regulations that impede entry to restrict competition, except for those justified on safety, environmental, and consumer protection grounds, and prudential oversight of financial institutions.
10. Legal security for property rights.

Source: Hayami (2003).

Looking back over Indonesian experience with controls and liberalisation in recent decades, there are perhaps three broad observations that may be made.¹¹

First, because in any specific market at any time there are usually pros and cons to regulation, it is best to be both realistic and pragmatic. It is not easy to generalize about the best speed or sequencing of reforms in any particular market. It is best to weigh up each situation on its merits. Greater reliance on market forces has notable advantages, but there are disadvantages as well. If the judgment is that allowing considerable flexibility to price and market mechanisms is likely to work well, and if the risks of doing so are small, then the inclination should be to minimize price and other controls. But if the judgment is that the risks of deregulating are substantial, then it will sometimes be appropriate to lean towards maintaining regulatory controls.

Because the issues of liberalisation and greater reliance on markets have social and political implications as well as economic ones, the pros and cons of policy changes in

¹¹ See the surveys in the 2002 World Development Report (World Bank 2002) and McMillan's recent book on *Reinventing the Bazaar: A Natural History of Markets* (McMillan 2002). See also the comprehensive survey of the recent experience of institutional reform in Indonesia in the March 2005 issue of *The Developing Economies* and the overview by Sato (2005).

each case need public discussion. It would best be recognized that in the jargon of the "Star Wars" film series, markets can be said to have "light-side" activities -- they foster higher levels of productivity, and the existence of fair and legal markets expand economic freedoms for citizen -- but there are "dark-side" activities in markets too -- corruption, rent-seeking, and black market activities of many kinds (including trafficking in women and children, money laundering, illegal trade of weapons, and so on). Greater freedoms, including greater freedoms in markets, can significantly expand the room for illegal as well as legal behavior. The danger that so called "non-state actors" who want to create their own private "states within a state" will take advantage of liberalized markets poses significant risks for regulatory agencies in developing countries. Understandably, concern about the implications of these risks sometimes leads policy-makers in developing countries to be cautious about signing up to proposals for pro-market reform.

Second, there appear to be at least two important considerations in support of tending to favour market-based approaches in Indonesia at present. One is that for various reasons (a weak legal system, limited budgets for regulatory institutions) the ability of state to regulate effectively is weak. One of the main difficulties is that the devil is in the detail. Different markets and different industries have very different characteristics. To design -- and what is even more important, to implement -- good pro-market policies effectively in any specific market requires a good understanding of both microeconomic principles as well as a sound institutional knowledge of the particular sector and industry.¹² Strong and effective regulatory institutions which can deliver these skills to governments across the region are rare. Yet, without these institutions, markets and industries are unlikely to work well.

Another consideration supporting pro-market approaches is that the direct and indirect costs of the numerous attempts that are made in Indonesia to suppress prices in are high. These costs include shortages (leading, for example, to fuel queues) and rationing (electricity), waste (water sector in both rural and urban areas), dual markets which often provide benefits to consumers with access to subsidized services but which penalize other consumers with poor access (education, health), and lack of maintenance (transport sector) and underinvestment which restricts sectoral and overall national growth.

Third, as against these arguments in favour of pro-market policies, given the widespread existence of market failure in Indonesia there are clearly often strong arguments, in principle, in favour of government regulation. For example, industrial pollution is widespread, monopolies and speculators often appear to attempt to exploit market power, public goods and merit goods such as education and health are undersupplied, various demerit goods (such as tobacco products and illegal drugs) are oversupplied, and it is widely believed that there is excess competition in many sectors leading to unacceptable loss of quality in products supplied to the market.¹³ But given the limited resources currently available to the Indonesian Government, difficult choices about

¹² Rodrik (2003) has recently noted that in discussing economic policies, it is often the case that "universal principles are not self-executing" and has emphasized the importance of paying close attention to local conditions when implementing economic reforms.

¹³ For example, following the recent crash of the Mandala airlines in Medan in early September with the loss of over 150 lives some media commentators suggested that cut-throat competition in the Indonesian airlines industry was endangering safety standards.

regulatory priorities need to be made. The most effective approach would seem to be to focus regulatory resources on selected key sectors and, at the same time, accept that effective regulation in quite a few other areas of lesser priority is just not possible for the time being no matter how desirable, in principle, regulation might be.

Selected Micro Issues of Governance

Public policy formulation about the various issues discussed above is likely to be enhanced if there is active participation from civil society in Indonesia. In Indonesia in recent years, especially since the liberalisations of political activities since 1998, civil society has become much more active than previously. And yet, activity alone is no guarantee that civil society participation will always enhance public policy making. In the Philippines, for example, civil society is extremely vigorous but the contribution of civil society to public policy discussion in the Philippines is not always of high quality.

There is, then, room for institutions of civil society in Indonesia to consider issues of governance within their own organisations at the micro level so that their activities can be strengthened and so that they can better contribute to discussions about the governance of the nation. In other words, there are important issues of governance in Indonesia to be addressed at the micro level -- within firms and public service institutions and NGOs -- as well as at the higher national level. The important implication of this is that the responsibility for improving the governance of Indonesia rests not just with high-level decision makers but also with citizens at many other levels of Indonesian society as well.

To illustrate just a few of the issues which need to be considered at these other levels it will be useful briefly to look at some challenges of governance in two sectors which contribute to public policy in Indonesia: universities and think tanks.

Universities

The higher education industry in Indonesia appears to face many of the structure-conduct-performance types of issues that are evident in other sectors of the economy. The industry is markedly dualistic with a leading government-supported sector of state universities that coexists with a large number of other private sector education institutes which often advertise themselves as universities but which vary greatly in quality.

There appear to be many issues of governance within the higher education industry in Indonesia that need attention. These might, as examples, include such strategic issues as: the structure of the industry, standards in the private sector education institutes, the financing of education, relative incentives provided for teaching, research and administration, and role of peer group reviews of professional work between institutions. Commenting on challenges facing Indonesian intellectual life over 30 years ago, Clifford Geertz summarised some of the main issues as follows (Geertz 1971):

"Indonesian intellectual life is centralized, over-organized, spasmodic, practical, and strongly influenced by economists. ... The spasmodic quality -- a kind of chronic distraction -- arises from the scattering of energies imposed by an irrational salary structure for academics which forces them into multiple occupations, and by the excess of essential tasks over people qualified to perform them. ... The combination of extremely low academic salaries, multiple

possibilities for earning supplementary income by intellectual, quasi-intellectual, and para-intellectual work, and the absence of an overriding ethic of vocation, has led to a pattern of intellectual life for which the most appropriate adjective is "busy". Sustained work is extremely rare. ... As an important part of the problem is money, an important part of the solution is also money. A program which only asks a half or third of its participants' time will receive (if it is lucky) the third half or the fifth third. ... For the fact is that although social research is highly approved of, even praised in Indonesia "in principle," the prestige of the research role, and thus of researchers, is very low -- in part because there is even less money in it than in teaching, writing for the public press, serving in administrative positions in either the universities or ministries, or writing unresearched reports (that is, personal opinions) about social problems. The first task of a program for developing the social sciences in Indonesia must be to move toward correcting this situation and establishing the research role as the axis, as in fact it is, of those sciences."

Arguably, many of these issues remain as relevant today because although the supply of and quality of universities has steadily improved during the past three decades, so the demands on the higher education have increased greatly as well. As a result, resources within the sector remain under severe strain.

Think tanks

It is now widely accepted that governance is enriched by good quality feedback from "second tier" social institutions including think tanks. Across developing countries in the Asian region the quality of think tanks varies considerably with perhaps the strongest think tank communities being in India and the Philippines. In general, issues facing think tank communities across the region include the following (Stone 2005):

- The overall weakness of the think tank community in some countries, both terms of both quality and quantity.
- Difficult domestic environments for intellectual activities in some countries which are not especially favourable for the operation of vigorous think tank activities; this is especially the case where there are strong, quasi-authoritarian states which are not used to active public policy debate.
- Shortages of money and other resources.
- Debates over objectives and modes of operation -- whether think tanks should be demand-led in their activities or whether they should be more active in trying to set regional policy agendas.
- How to respond to strong external pressures to take part in discussions about global policy issues that may not be felt to be as urgent as specific local issues.
- Internal governance issues concerning such things as independence, reliance on key external funding agencies, the role of advisory councils, and human relations procedures.

In recent years, the think tank community in Indonesia has become much more vigorous than previously and is now increasingly contributing to public policy debate. Nevertheless, many of the regional factors listed above are reflected within the think tank community within Indonesia. Similarly, a number of the issues identified by Geertz over 30 years ago would seem to be matters which are relevant to the governance of Indonesian think tanks today. The recent survey by Stone (Stone 2005) provides a useful summary of strategic and management issues which could usefully be considered by the think tank community in Indonesia and in other countries in the region.¹⁴

Conclusions

In setting out conclusions, a distinction needs to be made between on one hand, general conclusions about governance, and on the other, specific conclusions relating to particular sectors or firms. It is often the case that important aspects of governance issues need to be tackled at the firm or industry level rather than through an economy-wide approach. Many issues relating to law reform in Indonesia, for example, are specific to the legal sector and therefore broader generalizations about governance are of quite limited relevance. But broader generalizations can be useful as well, at least in setting out a main framework for reform in any particular sector. The main conclusions which emerge from the issues set out above are as follows.

First, effective governance reform at either the national (macro) level or at the level of any specific (micro) sector usually involves at least four key elements:

- The identification of a strategy or vision for change.
- The translation of the strategy into a detailed program for reform; programs should best identify expected results or outcomes set out in measurable performance indicators (MPIs).
- The effective implementation of the program.
- A focus on outcomes or results, and especially including the monitoring of progress against the initial MPIs.

Each of these steps is important. The steps would seem straightforward enough but many efforts at reform fail at one or other of the stages.

Second, many issues of governance in Indonesia remain unsettled and contested. This contributes markedly to a worrying situation where many observers comment on the "lack of rule of law" and the fact that arrangements in Indonesia are felt to be *kacau*. Measures that might be taken to respond to these issues include:

- Defining the official rules of the game more clearly in each sector; but doing so bearing in mind the current severe constraints on the capacity of the state.
- Streamlining government by simplifying regulations and procedures because, given the limited capacity of the state, there is over-regulation in many sectors in Indonesia

¹⁴ There is a growing literature discussing the role of research institutions and think tanks in contributing to policy discussion in developing countries. See, for example, the survey by Hovland (2003).

at present; government agencies might be encouraged to prepare lists of functions that they intend to eliminate so that they can focus on areas of higher priority.

- Accepting rather than resisting the role of markets; accepting, also, that attempts to suppress prices are frequently counterproductive and have many negative side-effects.

Finally, there are many important issues of governance in Indonesia not addressed in this paper: these include the large decentralisation of government in recent years, the overall financing of the military budget, the continuing need to tackle a gamut of issues related to the role of SOEs, and the need for legal reform. Each of these topics, however, is properly the subject of a separate paper.

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