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Is Indonesia Trapped in the Middle?*

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1. Introduction

Few countries have experienced such dramatic changes in economic fortunes and political governance as Indonesia. The world's fourth most populous nation and the tenth largest economy (in PPP terms), it experienced more or less continuous economic decline for at least half a century prior to the mid 1960s (van der Eng, 2002). By then it was one of the world's poorest countries, characterized in the leading development economics text of the time as 'a chronic economic dropout' (Higgins, 1968), and one with little prospect of development in the leading socio-economic survey of the period (Myrdal, 1968). Then, in a remarkable turnaround, from 1966 the country achieved rapid economic development for the next three decades, such that it was classified as one of the 'East Asian miracle economies' in the World Bank's (1993) major comparative study. Indonesia's per capita GDP more than quadrupled over this period.

However, shortly after it had graduated to the middle-income group of developing economies, and when rapid, East Asian style economic development seemed assured, the country experienced another major discontinuity. In 1998, during the Asian financial crisis (AFC), its economy contracted sharply, by more than 13%. This translated into one of the largest growth collapses in modern economic history, from peak to trough (ie, the average annual growth of about 7% during the

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preceding decades) of about 20 percentage points. This collapse was accompanied by, and triggered, a major political crisis, with the sudden end of the 32-year rule of President Soeharto in May 1998. As in the mid 1960s, the country's prospects were again regarded as exceptionally gloomy. The economy appeared to be in free-fall. The value of the currency was at one point just 10% of that pre-crisis. The modern banking system had collapsed. The country's territorial integrity was in doubt, with 'Yugoslav' type scenarios considered likely. Compounding these problems, there was no clear process – or historical precedent – for an orderly transfer of political authority.

Yet as in the mid 1960s, the doomsayers were incorrect. The economy recovered surprisingly quickly, and returned to a moderately strong growth trajectory of 5-6% from 2000. The political transformation was just as remarkable. From three decades of authoritarian, military-based, centralized rule in some respects centred on just one figure, Indonesia quickly emerged as Southeast Asia's most vibrant democracy, a status it retains a decade and a half after the transition according to comparative benchmarks. The country also undertook a 'big bang' decentralization in 2001 with the result that much administrative, financial and political authority has been devolved to sub-national governments. In sum, this was one of the most comprehensive and rapid reconstructions of a country's political institutions and processes in recent times, with only a brief loss of economic momentum.

This paper examines Indonesian economic development in the context of the widely discussed middle-income trap (MIT) literature,[1] which draws attention to the presence of per capita GDP thresholds beyond which there is an empirical regularity of growth slowdowns. One estimate puts this threshold at around $15,000 (in 2005 PPP dollars). Other authors raise the possibility of a multi-modal threshold, with a lower one of around $11,000. Extending this analysis to explain the causes of the growth slowdown, a variety of factors are argued to be relevant, including the quantity and quality of education and the share of high-tech products in exports. An alternative approach has been to investigate abrupt slowdowns, defined as large, sudden and sustained deviations from the growth path predicted by the basic conditional convergence framework. Aiyar et al (2013) examine these cases, finding that institutions, demography, infrastructure, the macroeconomic

[1] See also Perkins (2013), Eichengreen Park and Shin (2013), Felipe et al (2014),

environment, output structure and trade structure are all potentially associated with such outcomes. Theories have also been proposed that allow for multiple equilibria and convergence to higher and lower per capita incomes.[2]In addition, there is a country literature exploring growth slowdowns. The most widely discussed East Asian experience relates to Malaysia, where a range of economic and political economy factors are identified as contributing to this country's slow growth since the AFC. Much of this literature focuses on Malaysia's long-running affirmative action policies, and the politicization of them, embedded on almost six decades of continuous, virtually single-party political rule.[3]

Returning to the Indonesian case, with its record of economic dynamism and political transformation, the notion of a 'trap' therefore hardly appears relevant. If Indonesia can maintain the development momentum of the past decade and half, per capita incomes will double approximately every two decades, and the country would be on course to graduate to the high-income group within half a century. If it were to regain the momentum of the Soeharto era, this graduation process would occur more quickly still. Moreover, while the democratic transition is in some respects still incomplete, the prospect of violent and economically disruptive regime change – a prospect that by definition authoritarian regimes have to worry about – has receded given the existence of functional democratic institutions.

Although the notion of a 'trap' is therefore not analytically helpful, Indonesia's growth rates remain below those of East Asia's most dynamic economies, as represented by China for the past three decades and the Asian NIES earlier. In spite of the progress, the economic policies of recent and current administrations have struggled to achieve faster economic growth. After surveying Indonesian economic development in section 2, the focus of this paper in section 3 is therefore on the factors that are holding back the country's growth dynamism. These obstacles to faster growth are not amenable to quantitative explanation, and so we develop an analytical narrative that identifies the principal factors. A concluding section summarizes our main arguments.

[2] See for example Agenor and Canuto (2012) and Eeckhout and Jovanovic (2012).
[3] See Hill, Tham and Ragayah (2012) and Wing (2011).

2. Indonesian economic development: an overview[4]

Indonesia experienced sustained and rapid economic development for the first time in its history from 1967. Under Soeharto, who took power in early 1966, and guided by a group of gifted economic policy makers, the country rejoined the global economic community, restored macroeconomic stability, adopted a welcoming attitude towards the private sector, including foreign investment, and began to rebuild the dilapidated physical infrastructure. Development was further boosted by large foreign aid inflows, the accelerating green revolution in agriculture, and, in the 1970s, high energy prices.

The economy responded surprisingly quickly to the new regime (Figure 1).[5] Over the period 1967-96, that is, a year after Soeharto's accession to power and the year prior to the Asian financial crisis, annual economic growth averaged an impressive 7.4%, translating into per capita growth of slightly more than 5%. There were distinct episodes in this development record, with very strong growth during the 1970s and again from the late 1980s, alongside much slower growth in the early and mid 1980s. The growth variability is explained by the interplay of a range of exogenous and domestic factors. Indonesia enjoyed large windfall revenue gains during the 1970s, and much – but certainly by no means all – of this revenue was invested in productivity-enhancing activities, particularly rural infrastructure. As energy prices began to fall rapidly in the early 1980s, Indonesia looked precarious, with the energy sector contributing two-thirds of fiscal revenue and three-quarters of merchandise exports. However, unlike most other developing country commodity exporters outside the Middle East, Indonesia managed to avoid the 1980s debt crisis through adroit macroeconomic management and comprehensive microeconomic reform. As a result, new economic drivers emerged, particularly export-oriented labour-intensive manufactures, such that strong growth was restored by 1987.

[4] This paper draws on some of the authors' recent and ongoing research, in particular Aswicahyono and Hill (2014a, 2014b). The Indonesian economy is monitored regularly in the 'Survey of Recent Developments' published since 1965 in the four-monthly Bulletin of Indonesian Economic Studies.

[5] See Hill (2000) for more details of the events discussed in this paragraph.

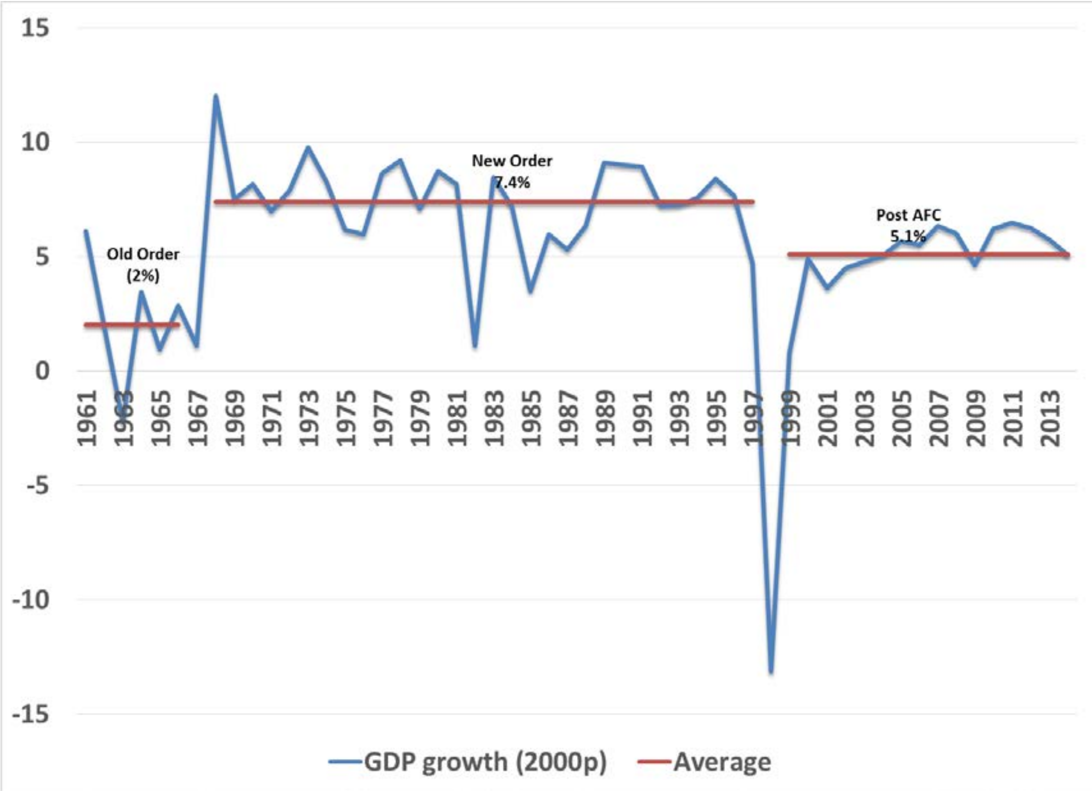

Figure 1: Indonesia: GDP Growth, 1961-2014

This growth was maintained until 1997 when, as noted, Indonesia experienced a deep economic and political crisis. Although the AFC originated in Thailand, and it also severely affected Korea and Malaysia, Indonesia was the most adversely affected because the economic crisis triggered regime collapse, with no immediately apparent institutionalized succession scenarios. In the event, the democratic transition proceeded much more smoothly than most observers dared to hope, and by 2000 economic recovery was underway. By 2004, per capita income (and associated social indicators such as poverty incidence) had recovered to pre-crisis levels. By any reasonable yardstick, Indonesia's twin transitions, from economic crisis to growth, and from authoritarian to democratic rule, were impressive.[6] The country also navigated the 2008-09 global financial crisis (GFC) with little difficulty, owing to good policy (including reforms introduced in the wake of the AFC) and some good fortune (Basri and Hill, 2011). Nevertheless, as Figure 1 shows, economic growth during the democratic era has lagged that achieved during the Soeharto period by a little over two percentage points. (Population

[6] See Pritchett (2011) for an analysis of the Indonesian record in comparative perspective. The closest comparator nation is arguably the Philippines. The latter's economic-political crisis of 1985-86 was very similar both in its origins and severity, but it took 20 years (1983-2003) to recover to pre-crisis levels of per capita income. See Balisacan and Hill (eds, 2003).

growth during the two periods was similar.) Part of the explanation for the slower growth was the complicated post-crisis recovery trajectory in the early 2000's, as firms and the financial sector restored balance sheets, and also the short-lived slowdown during the GFC. However, as the figure also shows, even at its peak, growth since 2000 has not matched the average for the earlier period. For several years in this recent period, moreover, Indonesia again enjoyed exceptionally favourable terms of trade, driven by China's demand for raw materials. The data therefore portray a story not of a 'trap' but rather one of slowing growth. It is to this issue that we return in the next section.

Five dimensions of Indonesia's economic performance warrant attention. First, the growth of total factor productivity portrays a broadly similar story to that of the national accounts. There is a substantial literature on total factor productivity in Indonesia.[7] Some of the detailed estimates are dated, and we therefore draw upon the three major sets of cross-country international estimates, by the Conference Board, the Asian Productivity Organization, and the Groningen/Penn World Tables. The results vary depending on estimation methodologies, data sources and assumptions. Figure 2 summarizes the results for the three series, which show broadly similar trends. There is considerable year-to-year volatility, reflecting Indonesia's growth volatility and also its variable input growth, especially investment. Moreover, consistent with the empirical regularity known as "Verdoon's Law", the fluctuations in TFPG are generally similar to those in GDP growth. In particular, there was a sharp reduction in 1998, similar in magnitude to that of the economic contraction. Abstracting from these outlier cases, for most of the period TFP growth is positive, and generally in the range 1-4% per annum. A fitted trend line, excluding the outlier years, does indicate a declining TFP growth rate since the early 1990s, suggesting that the secular decline in underlying growth discussed above may have had its origins before the AFC. It also needs to be emphasized that Indonesia's total factor productivity has been lagging global benchmarks over the past decade, and also its middle-income ASEAN neighbours, with the exception of the Philippines.

[7] See Aswicahyono and Hill (2014b) on which this paragraph draws.

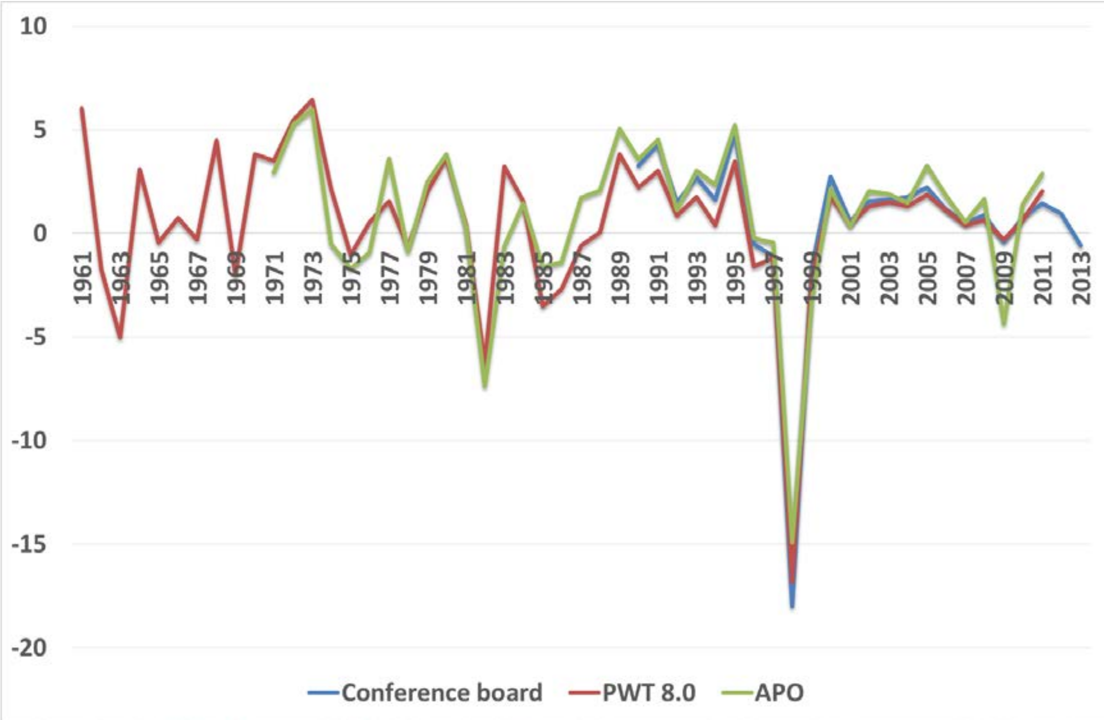

Figure 2: Estimates of Indonesian Total Factor Productivity Growth, 1961-2012

Second, Figure 3 places Indonesia's growth trajectory in comparative perspective. The country commenced rapid growth at about the same level of per capita income as China and India, but a good deal lower than the Philippines and Thailand. Twenty years into this growth, that is, by the late 1980s, it had overtaken the Philippines and had a per capita income significantly higher than both China and India. However, the combined effects of the AFC and China's accelerating growth meant that it slipped behind China in the early 2000's, and now has a per capita income of a little more than half the latter. Although India has grown faster for periods of the past decade, Indonesia's per capita income remains substantially above both it and the Philippines.

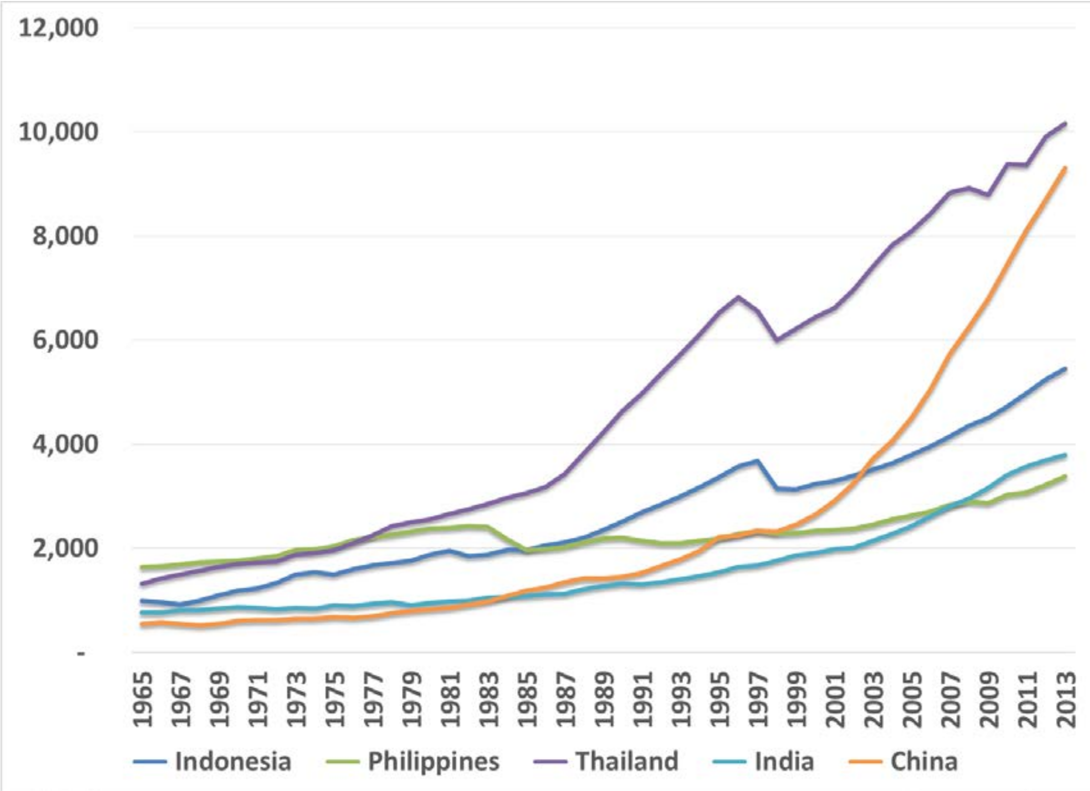

Figure 3: Per Capita GDP, 1965-2013, Indonesia and Comparators

Third, Indonesian economic growth may also be viewed with reference to that of the frontiers, the latter proxied by the US. Relative to the US, over the period 1965-2013, Indonesia's per capita GDP approximately doubled, and is now about 17% of the US figure. As with the other countries in the comparison, excluding the Philippines, this is a clear case of 'catch-up', albeit at a much slower pace than China. This confirms the estimates of long-run economic growth presented by Perkins (2013, Table 1.1). Over the half century 1961-2010, Indonesia's real per capita GDP (in PPP terms) rose 5.7 times, compared to China's 12.4, Thailand's 8.2 and the Philippines 2.1.[8]

[8] The frontier growth rates in this East Asian sample were Korea and Taiwan which achieved increases in GDP per capita of 15.6 and 16.8 respectively over this period.

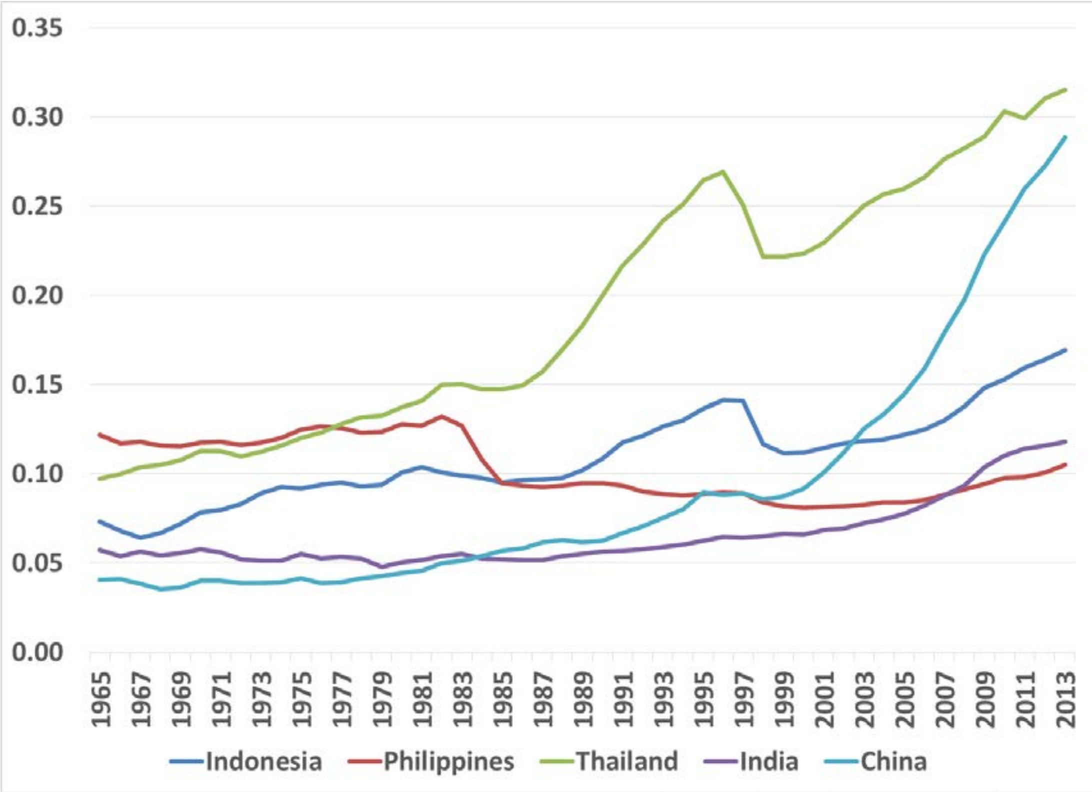

Figure 4: Per Capita GDP Relative to the Frontiers, 1965-2013, Indonesia and Comparators

Fourth, in any assessment of the country's economic performance and political economy, it is important to keep in mind Indonesia's geography. It is the world's largest archipelagic state, featuring exceptional diversity in its economy, human settlement and ecology. Java-Bali, with 7% of the land area, generate about 60% of total GDP. Greater Jakarta constitutes about one-quarter of the economy. Most modern manufacturing and service activities are located on these islands, which also serve as the major gateways to Indonesia's international commercial engagements. The very large spatial differences in productivity are illustrated by the fact that, among the country's 34 provinces, the per capita income of the richest is approximately 15 times that of the poorest. At the sub-national level of administration, the districts and municipalities (kabupaten and kotamadya), now numbering over 500, and to which the major decentralization of 2001 was directed, the richest regions have a per capita income more than 50 times that of the poorest. We return to this issue below.[9]

[9] See the papers in Hill (ed, 2014) for a wide-ranging examination of regional issues in Indonesia.

A fifth dimension concerns social progress. Economic growth has resulted in a rapid decline in poverty incidence.[10] Head count poverty incidence has declined from around 55% in the mid 1960s to less than 15% currently (Figure 5). The most rapid decline occurred during the Soeharto era, when growth was faster, inequality was stable, and most of the growth was labour-intensive in nature (especially in rice and manufacturing). Poverty incidence rose during the AFC but, as with per capita income, it had returned to pre-crisis levels by 2004. Over the past decade, the rate of decline has been slower, owing to the slower economic growth, and a significant increase in inequality as measured by the gini ratio. This increased inequality, one of the sharpest in the developing world over this period, is a subject of much debate. The poor record of formal sector labour absorption since the late 1990s, together with a probable weakened commitment to 'egalitarian' tax and spending programs, are likely to have been key factors in the increase. Since the AFC, the Indonesian government has began to develop targeted social safety net programs, with some success, although the expenditures remain very modest and they evidently have very little impact on post-tax and transfer inequality.

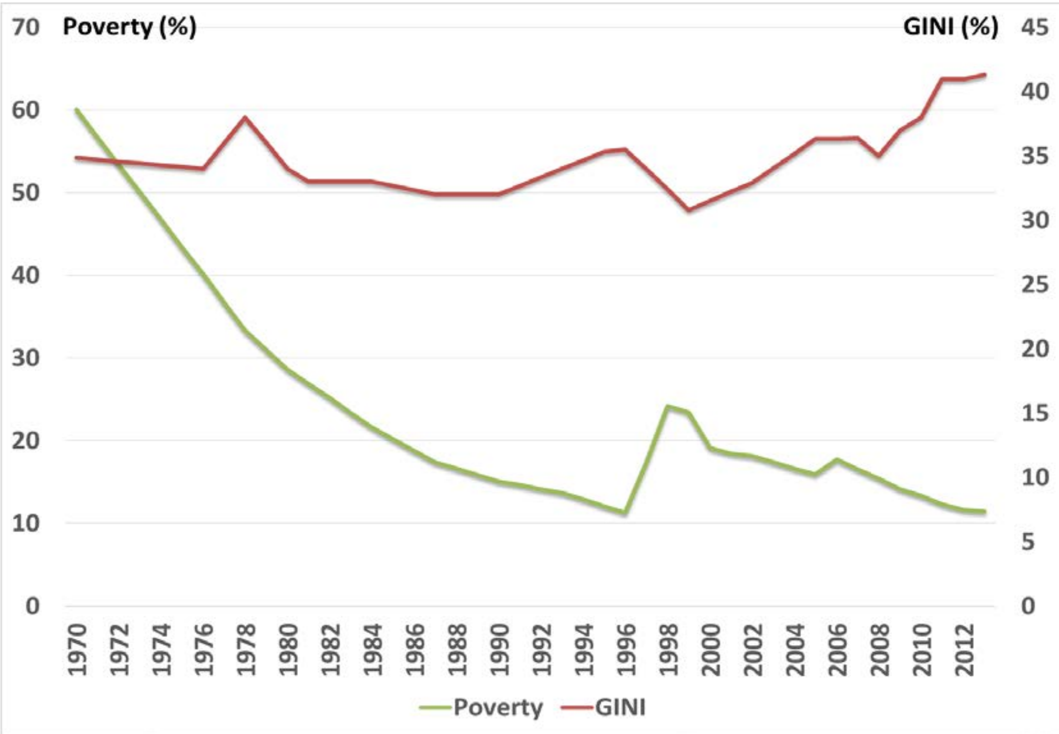

Figure 5: Poverty and Inequality in Indonesia, 1970-2014

[10] Manning and Sudarno (eds, 2011) provide a comprehensive analysis of Indonesian living standards, on which this paragraph draws. Wai-Poi (forthcoming) provides a comprehensive review of trends in poverty and inequality since the 1980s.

Finally, the drivers of Indonesian economic growth have changed over this period. This is to be expected. In the 1960s, Indonesia was an overwhelmingly agrarian economy, with over half its economy and three-quarters of its labour force in agriculture. This sector now contributes slightly over 10% of GDP. This is a conventional story of rapid economic growth resulting in significant structural change. Services have grown consistently quickly in both periods, driven by liberalization, the IT and transport revolutions, the consumption patterns of a rising middle-class and, for much of the period since 2005, an appreciating real exchange rate. But one contentious feature of the sectoral growth story is the industrial slowdown. Manufacturing growth exceeded 10% in almost every year over the period 1967-96, but since 2000 it has grown at about half this rate (Figure 6).

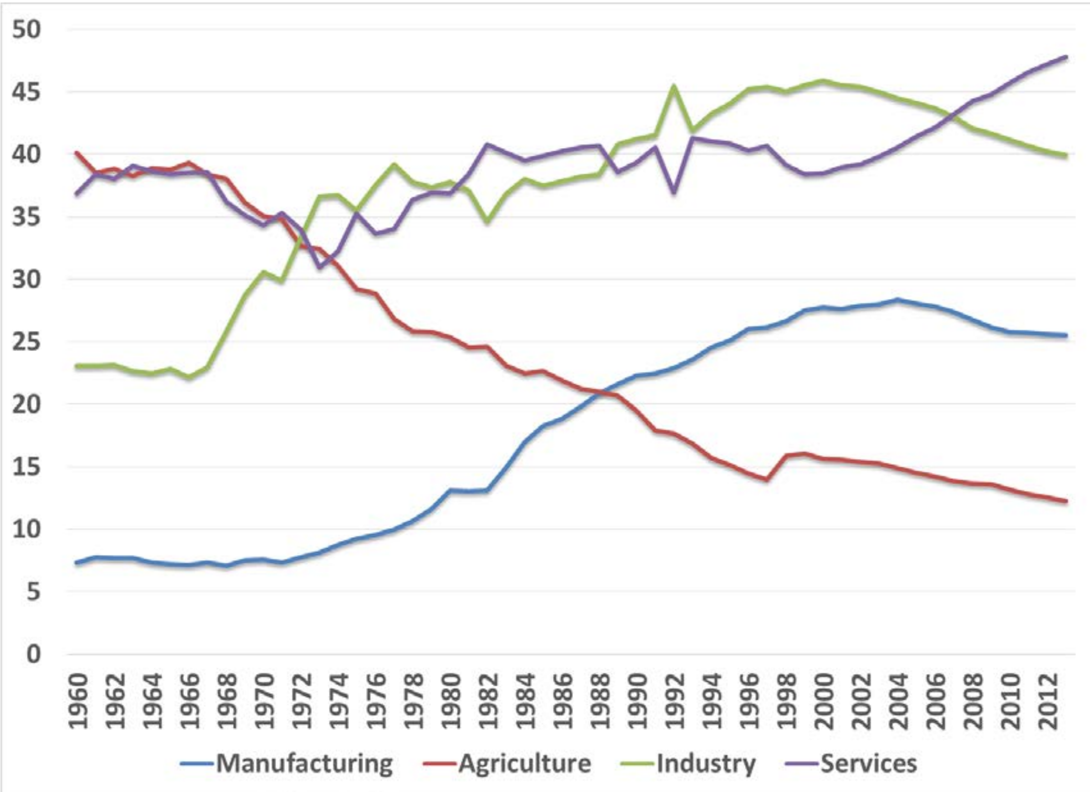

Figure 6: Indonesia: Sectoral Growth, 1961-2014

This has prompted a vigorous debate about alleged deindustrialization, that in some quarters is also (mistakenly) attributed to a variant of the middle-income trap. Two points need to be made with reference to the country's spurious deindustrialization debate. First, it overlooks the fact that, relative to the country's per capita income, Indonesia's share of manufacturing value added in GDP is actually larger than that predicted by a standard cross-country regression equation.

Figure 7 plots manufacturing value added shares and per capita GDP at constant 2005 prices for Indonesia and 40 countries, both developed and developing, for the period 1960-2012.[11] It shows that its share is consistently higher over time than countries with similar per capita incomes. The same exercise is undertaken for employment shares over this period, as reported in Figure 8. In fact, Indonesia is ‘below average’ with respect to employment shares. Of course, these findings have no normative implications, in the sense that there is no necessary ‘desirable’ share for manufacturing. But they serve as a corrective to simplistic assertions that Indonesia’s manufacturing share is ‘too low’.

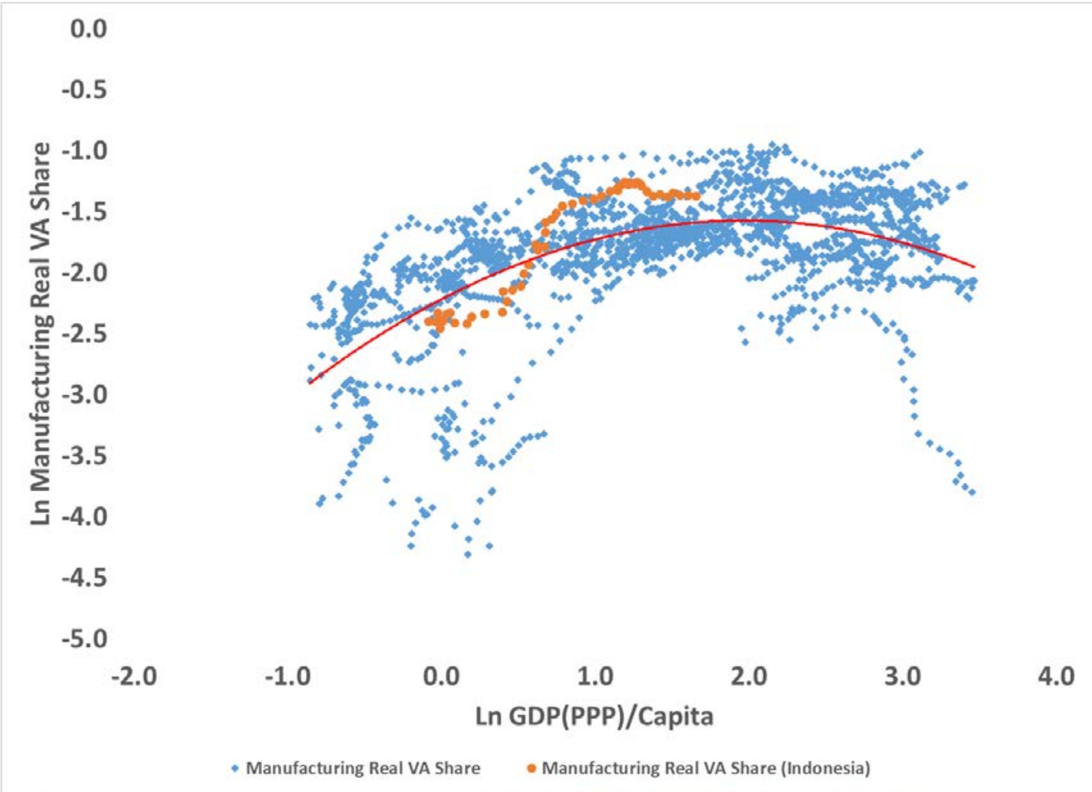

Figure 7: Manufacturing Output Shares, Indonesia Compared

[11] The employment and real value added shares are from the Groningen manufacturing data sets.
See http://www.rug.nl/research/ggdc/data/10-sector-database
GDP/capita is in millions of 1990 US$, converted at Geary Khamis PPPs.

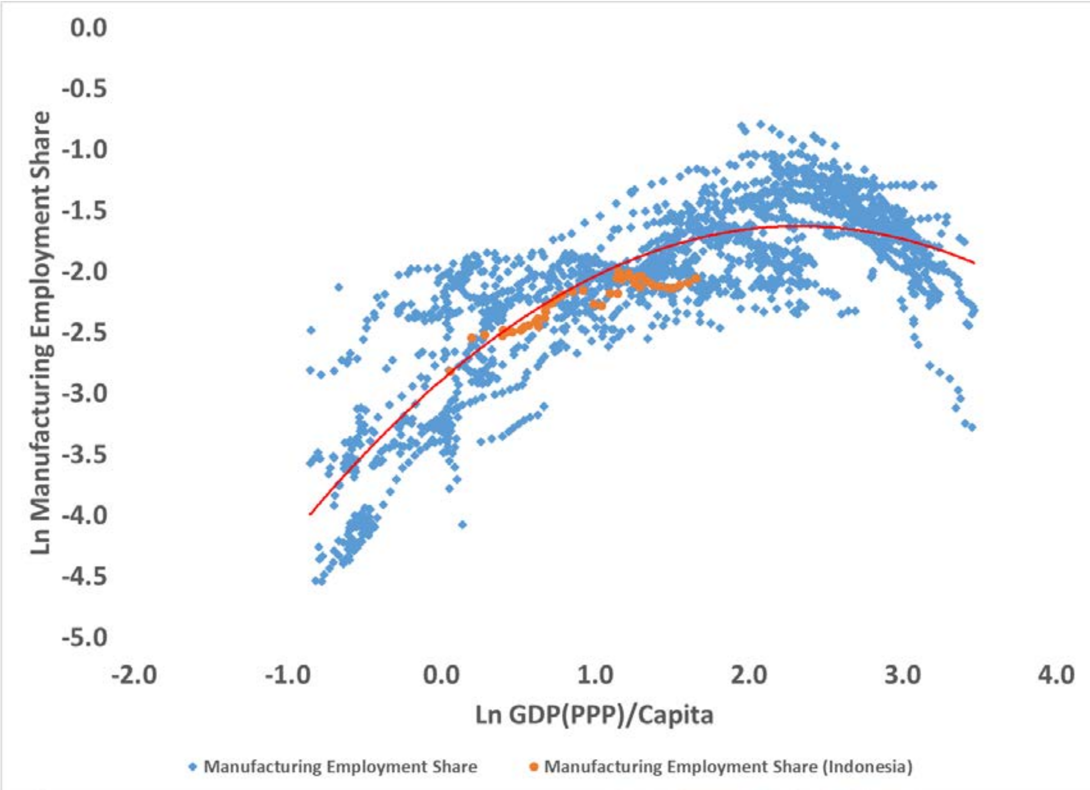

Figure 8: Manufacturing Employment Shares, Indonesia Compared

In fact, what the comparative data highlight is another, less discussed issue, namely that Indonesian manufacturing is relatively more capital-intensive than its comparators. That is, its output share is above average and its employment share is below average. Here too, the results carry no normative implications. Indonesian industry may be more capital-intensive for a range of reasons, including its sectoral mix and institutional settings. But the data are at least suggestive that the labour market regulations are pushing the manufacturing sector towards premature capital intensity at the cost of weak labour absorption. We also discuss this issue below.

Second, in any case, it is not necessary to employ middle-income trap theories to understand the reasons for the industrial slowdown since the AFC. At least three sets of factors are at work.[12] First, Indonesia has experienced historically high terms of trade for the most of the period since the early 2000s. Thus there have been the familiar Dutch Disease factors at work, resulting in a larger natural resource sector (measured at current prices), and also a real exchange rate appreciation and hence a squeeze on non-commodity tradable sectors like

[12] See Aswicahyono et al (2010) for more discussion.

manufacturing. Second, key elements of the Indonesian policy regime have hindered the competitiveness of the hitherto dynamic manufacturing export sector. Mandated minimum wages have risen significantly, while the efficiency of internationally oriented logistics and infrastructure has declined. We discuss these factors in the following section. Third, the scale effects of the rise of China as the major supplier of a wide range of manufactures has been such as to lower the global supply price of these goods, thus depressing returns for labour-intensive manufacturers like Indonesia.

3. So far so good, but why not better?

Indonesia's record of long-term growth is superior to that of most developing countries. The explanations for this record are beyond the scope of the paper, but they are well documented and consistent with the general literature on the determinants of economic growth.[13] That is, macroeconomic management has been reasonably good; Indonesia is moderately open to international trade and investment; it has been politically stable for most of the past half century; poverty and social indicators have improved significantly; and there have been positive neighbourhood effects. However, the purpose of this paper is to explore why the country has not grown faster still, at rates comparable to those at the East Asian frontiers, and why growth appears to be somewhat slower in the democratic era than that of the Soeharto era. Democracy in principle might be expected to the growth-supporting, even if the empirical evidence is mixed.[14] It needs to be emphasized at the outset that these questions are not amenable to precise quantification. We organize our arguments around four growth-inhibiting factors, and by implication highlight some of the reforms needed to achieve faster growth.

First, however, it is important to keep in mind Indonesia's political economy context, and especially the fundamental transformation in its institutions that occurred in the transition from the Soeharto-era authoritarianism to the highly pluralistic and occasionally volatile democracy that has emerged since 1999.[15] At least seven key political parameters have changed, and these together have far-reaching implications for economic policy making. First, there is a weakened presidency.

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[13] See for example Hill (2000) and Temple (2003).
[14] For a comprehensive recent survey arguing that the link is a positive one, see Acemoglu et al (2015).
[15] See Crouch (2010) for an authoritative assessment.

Although deriving legitimacy from a popular, directly elected mandate, the president has to contend with many more checks and balances than were present during the Soeharto era, when he himself was the key political institution. Second, and central to the first proposition, the president invariably presides over a rainbow coalition of parties both in cabinet and the parliament (DPR). The coalition members have little personal or institutional allegiance to the president, and their support on key policy issues cannot be assumed. Third, the bureaucracy remains a powerful yet largely unreformed institution, but one that is now subject to significantly greater community accountability, especially through the Corruption Eradication Commission (KPK), which we discuss below. One result of this new institutional configuration is a reluctance in certain sections of the bureaucracy to take key spending decisions, especially major infrastructure projects. Fourth, the DPR, which served as a rubber-stamp for Soeharto, is an assertive and sometimes unpredictable institution, in which key government policies and bills may be rejected or substantially modified. Fifth, the judiciary, also suppressed under Soeharto, has become an important yet also often unpredictable actor, with a propensity to overturn government bills and regulations. Sixth, governments now have to contend with a highly active and noisy civil society that, whether through social media or street demonstrations, can challenge and shape policies. Finally, much of the public sector administrative and financial resources have been devolved to the country's sub-national tiers of government, posing in turn complex inter-jurisdictional and coordination challenges on issues as diverse as health, education and infrastructure (see below).

a. Ambivalence towards globalization:

Indonesian public opinion has always been somewhat reluctant to embrace liberalism and globalization. And yet it is frequently observed that, with its 17,000 islands, 'Indonesian was made by God for free trade'. The pendulum has swung from the global disengagement of the early 1960s, when the country joined the 'Peking-Pyongyang-Hanoi-Phnom Penh-Jakarta' axis of newly emerging forces, through to a very open regime from the late 1960s, growing state intervention during the 1970s oil boom, and then a major deregulation (incidentally never referred to as 'liberalization' in government pronouncements) from the mid 1980s. It might have been expected that these reforms would have been reversed over the past two decades, given the deep unpopularity of the IMF rescue package in

1997-98, the perceived lack of support from the international donor community more generally, and the shock of the GFC of 2008-09.

Nevertheless, the economy has remained reasonably open over this period, at least in relation to comparators. Average tariffs are moderate at about 6%, and continuing to trend down slightly. Non-tariff barriers remain a challenge for economic reformers, but have generally been contained to some agricultural products (including a prohibition on rice imports for several years) and heavy industry. Total exports and imports are equivalent to about 55% of GDP, the lowest in ASEAN apart from (probably) Myanmar, but this in part reflects the country's size. The country remains somewhat open to foreign investment, with the stock of realized FDI equivalent to about 14% of GDP, the lowest among the major ASEAN economies alongside the Philippines. The country's economic freedom ranking, at 131, is the lowest among the ASEAN 5 but above that of Vietnam (at 145).

Basri and Hill (2004) refer to this outcome as a case of being 'precariously open'. There are persistently pro and anti-reform currents, and in large measure they balance each other out. The former includes the continuing – though perhaps waning – influence of a partly insulated technocracy in the cabinet, able to resist special pleading pressures. Reformers can also point to past successes, especially in the 1980s, that built up coalitions in support of reform. They are also able to point to the general rule of thumb in Indonesia, that once tariffs are much above 25%, especially for high value to weight products, smugglers are in business. At the margin also, the ASEAN Economic Community (AEC), taking effect from December 2015, will constrain some trade policy excess.

However, the country's rising economic nationalism in recent years has intensified protectionist pressures (see Patunru and Rahardja (2015) for a recent survey). This policy stance, combined with declining commodity prices, has resulted in indifferent export performance in recent years. In response, much of the official rhetoric continues to emphasize a variety of unproductive strategies. One example has been discussions about the impact of the AEC, and the proposed Regional Comprehensive Economic Partnership (RCEP) among 16 Asia-Pacific economies (ie, ASEAN plus 6). Outgoing Industry Minister Hidayat reflected the continuing priorities of his department, arguing the government should issue "bolder and more protectionist regulations, including more fiscal incentives and non-tariff barriers."

Moreover, he said, “basic industry is most important, as it prevents massive imports …”[16]

Meanwhile, Indonesia continues to underperform in the crucial area of connecting to global production networks (GPNs). These vertically integrated, many-country, cross-border production and buying operations are now the major form of intra-East Asian trade. Within ASEAN alone, they account for almost 50% of trade within the region (Athukorala, 2010). Although concentrated principally in the electronics and automotive industries, they are an organizational structure that is relevant to any products that comprise discrete production processes with diverse factor intensities. Most of this trade is intra-firm in nature, and thus it is dominated by multinational enterprises (MNEs). Indonesia is a relatively minor participant in these networks, and is thus missing out on major commercial opportunities and employment creation. Although it is the largest economy in Southeast Asia, in 2010-11, for example, it accounted for 0.5% of global ‘network trade’, much lower than its Southeast Asian neighbours, Malaysia (2.6%), The Philippines (1.2%), and Thailand (1.6%).

The reasons for this under-performance are both well known (Soejachmoen, 2012), and amenable to policy intervention. Participation in the GPNs requires open trade and investment policies, since the parts and components frequently cross international boundaries, and much of the production occurs within MNEs. They also require highly efficient logistics infrastructure, including port movements, customs procedures and port-to-factory transport. Competitive labour inputs have to be available, across the range from unskilled to managerial staff. In these three key areas, Indonesia lags, as demonstrated by some of the comparative indicators presented below. Yet they are all amenable to relatively straightforward policy reforms, of the sort that Indonesia undertook for a period in the 1980s, and that even slower reformers such as the Philippines have initiated. The absence of reform does not mean that Indonesia is excluded from these industries. For example, its automotive industry is now one of the largest in Southeast Asia. However, its industries will be primarily domestic market oriented, and Indonesia will forego the opportunity to emerge as a major international hub the way that

[16] Jakarta Post, 20/8/2014.

Singapore and Thailand have, in the electronics and automotive industries respectively.

Compounding these problems is Indonesia's decision not to participate in the negotiations concerning a second round of the International Technology Agreement, ITA II. The ITA governs the trade in electronic components. Recognizing the reality of global production networks, and that final electronics products include components produced in many countries, there is free trade for these products among signatories to the ITA. Originally the ITA focused mainly on components. However, the distinction between components and final goods is now increasingly blurred. Therefore, under ITA II it is proposed to extend the coverage to electronics products. Several major electronics producers, among them Singapore, Malaysia and Japan, have already signed on to the accord. However, Indonesia has decided not to participate in the negotiations, presumably owing to concerns that its already protected electronics goods industries will come under further import pressure.

Meanwhile, much public policy discussion focuses on the need to 'revitalize' manufacturing through selective industrial promotion initiatives, particularly in 'high-tech' activities. There is a strong case for greater government expenditure in support of knowledge-based activities. But when the country ranks second lowest in the recent PISA education results (see next section); when it is substantially excluded from the dynamic East Asian and global production hubs by its inadequate infrastructure and ambivalence to foreign investment; when widespread corruption stymies many of the government's major spending programs; when the labour market is unable to function as the transmitter of prosperity; when property rights are uncertain owing to unexpected judicial outcomes, developing a bold new R&D strategy is very much a second order priority for the foreseeable future. In any case, the government currently spends only about 0.1% of GDP on R&D and 0.3% on higher education. (Private sector spending on the latter is about three times this figure, but on the former it is negligible.) Until the recent major reform of energy subsidies, the government was spending about 10 times more on these than it was on R&D and higher education. Even after the reforms, subsidies expenditure remains significantly higher.

b. Education and the Labour Market

Indonesia has achieved impressive gains in education since the 1970s in overcoming the colonial era backlog, with major expansions in enrolments at all levels. The country is now close to achieving universal literacy for its school-age population, and there is a strong commitment to education funding, through a law that mandates that 20% of the government's budget shall be allocated to the sector, net of transfers and subsidies. However, the country lags in terms of the high post-primary dropout rates, and also according to most comparative 'quality' indicators, such as international examination performance. For example, according to the latest round of PISA rankings, computed by the Organisation for Economic Cooperation and Development, Indonesia ranked 65th out of 66 countries. Admittedly, many of the countries in this survey are high-income, and the survey was selective in several developing countries. Figure 9 summarizes Indonesia's education indicators in comparative perspective. While as noted the quantitative expansion – here proxied by the Barro-Lee years of schooling – has increased significantly, on practically every quality indicator, from the two major international comparison exercises, TIMMS and PISA, Indonesia falls behind its neighbours, and with little sign of relative improvement.

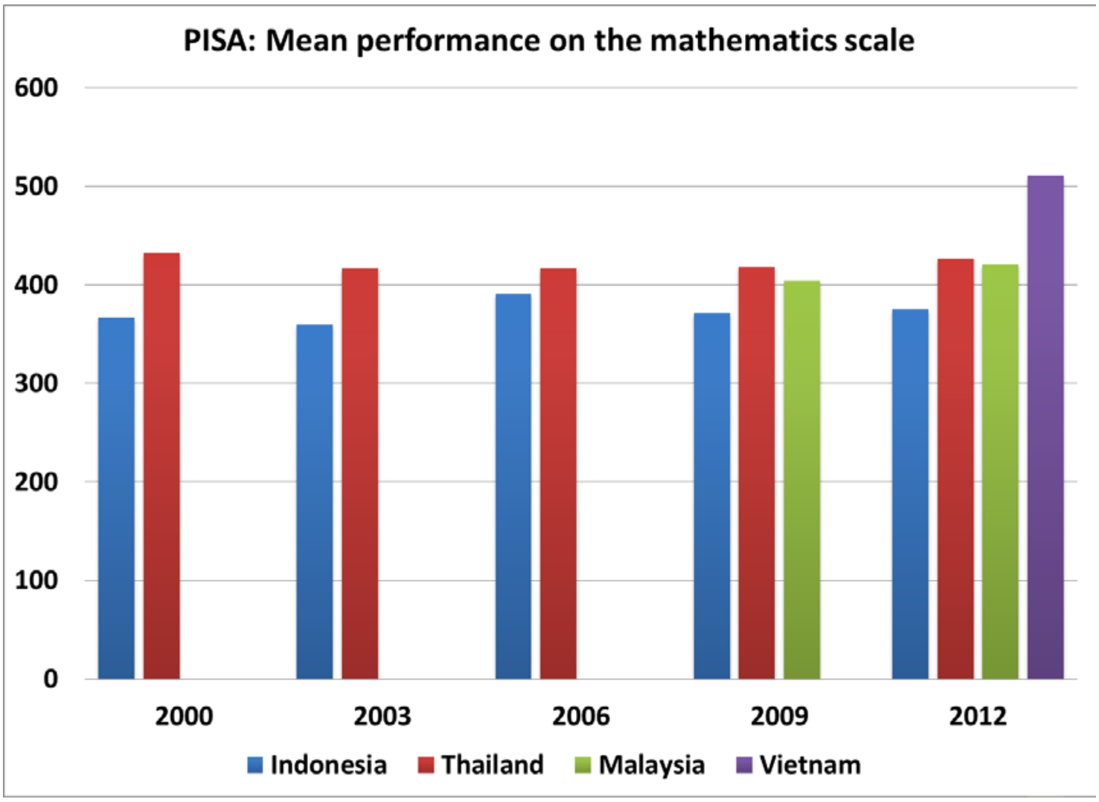

Figure 9: Comparative Education Indicators, Indonesia and Neighbours

Education indicators typically adjust slowly, as broader societal and family factors are influential determinants. It may be the case that this lagging performance reflects the country's historical under-investment in education. However, recent survey research indicates that the problems are deep-seated, and will not necessarily be overcome by the higher funding allocations. For example, although teacher salaries have increased in recent years, teacher absenteeism and poor quality instructional techniques persist. Examinations processes and results are frequently corrupted.[17]

Indonesia also faces major challenges in higher education, which will become more pressing as the country progresses through the ranks of the middle-income group. This sector is growing extremely rapidly, with about 5 million tertiary students enrolled currently, up from 2,000 at the time of independence in 1945.[18] Within the university sector, historically state universities, which were run as extensions of the civil service, dominated the system. However, the government spends only about 0.3% of GDP on higher education, just one-quarter of the total national expenditure, and thus it has had to recognize the reality that most of the growth will be in the private sector, either through a de facto 'privatized' state university system, or through private institutions. The government remains ambivalent about deregulating and internationalizing the system, preferring to maintain the historically tight regulations over state institutions, and providing little of the requisite regulatory framework that would enable a more effective private system to develop. Examples of underinvestment include arms-length information flows, trusted accreditation procedures, support for staff upgrading and international collaborative networks. As a result, the quality of tertiary institutions is highly variable, with small pockets of excellence alongside large areas of rudimentary quality. Funding support mechanisms, particularly for able but needy students, are also largely absent. Thus, none of the country's tertiary institutions rank prominently in international comparisons, including also those just for developing Asia.

These educational challenges are compounded by related labour market problems of weak formal sector employment growth and skill mismatches. Here a brief

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[17] See Suryadarma and Jones (eds, 2013) for a detailed analysis of Indonesia's education challenges.
[18] This paragraph draws on Hill and Thee (2012).

recourse to history is useful.[19] Over the period 1966-96, formal sector employment and modern sector wages grew strongly. This was an environment, like much of East Asia over this period, of strong, labour-intensive economic growth, combined with repression of labour rights. The AFC resulted in a sharp fall in formal sector employment and real wages. Since the labour market was flexible, much of the impact was on the latter (which was one reason why poverty did not increase as much as was feared). The sudden democratic transition unleashed powerful 'pro-labour' sentiments, which resulted in labour's freedom to organize, rapidly increasing mandated minimum real wages, and punitive severance pay provisions. The first of these changes was of course welcome, but the latter two, combined with slower growth, resulted in anaemic formal sector employment growth for much of the period since 2000, especially in the manufacturing sector, which had been the source of much of the dynamic employment growth (Aswicahyono et al, 2010).[20] Combined with the strong real exchange rate over much of this period, the result was that Indonesia lost competitiveness in international markets for labour-intensive manufactures.

Trends in unit labour costs (ULCs) illustrate these outcomes (Figure 10A). The first series (Figure 10A) shows labour productivity, average wages and ULCs for Indonesian manufacturing, as estimated from the national accounts (for value added), and wages and employment from the national labour force survey (Sakernas). The results show average wage growth quickly outstripping labour productivity over the period 2000-12, resulting in ULCs more than doubling. The sharpest increase in ULCs occurred in the early 2000's, and again over the period 2010-12, when nominal wages rose quickly, while productivity increased very slowly, especially in the latter years. The next figure (Figure 10B) provides an alternative set of estimates, derived from the annual Industrial Survey of manufacturing firms, employing at least 20 workers (Statistik Industri, SI). Although the results for the wage and productivity series differ somewhat, and the SI data are more volatile, the ULC series are broadly similar and these data therefore corroborate the first set of estimates. Both series, moreover, predate the large

[19] See Manning (2014) on which this paragraph draws.
[20] Manning (2014) concludes that formal sector employment growth did begin to increase from around 2009, as the commodity boom intensified. It is probable that this increase has been short-lived, as commodity prices have fallen since 2012 and given the large formal sector minimum wage increases in 2013.

nominal wage increases that occurred in 2013 in the run-up to the 2014 parliamentary and presidential elections, increases that occurred just as the country's terms of trade continued to deteriorate.[21]

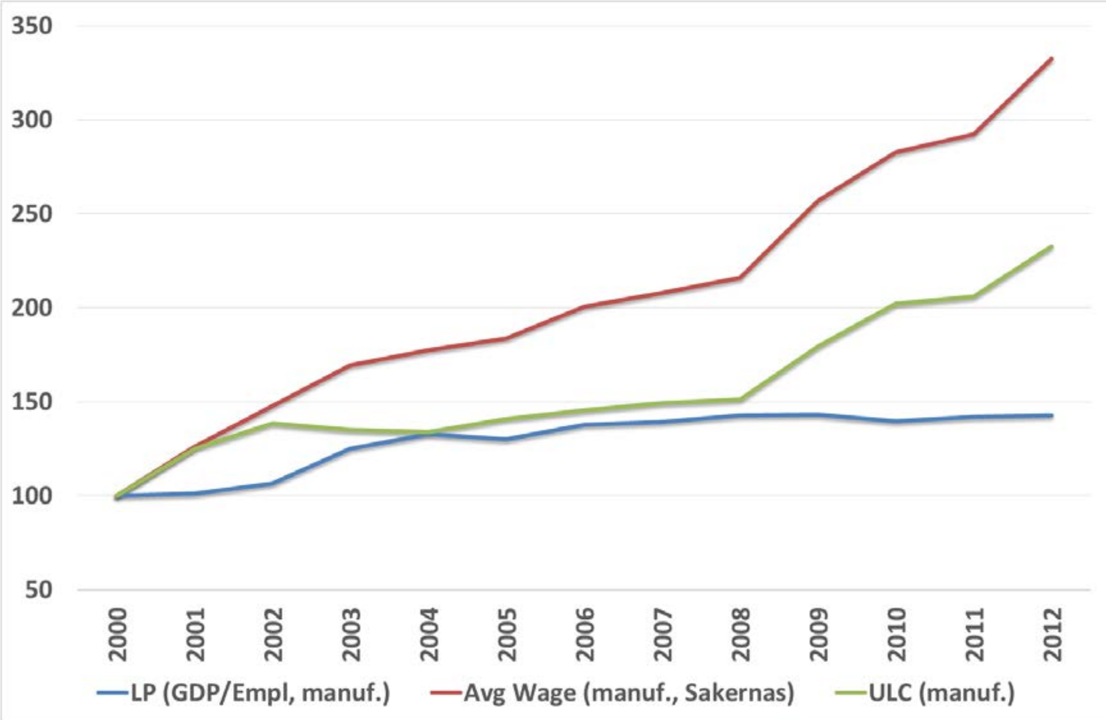

Figure 10: Wages and Unit Labour Costs in Indonesia

c. Infrastructure

Indonesia's infrastructure performance has been studied intensively, and it receives high priority in official policy statements through the formulation of master plans and logistics blueprints to reduce transport costs and increase their reliability. President Widodo's maritime vision, released in May 2015, was just one of many such pronouncements over the decades. The problem is that inter-island transport costs are very high in this, the world's largest archipelagic state. High transport costs push up the general cost structure, particularly for more remote regions, and thus there are large inter-regional price differences. For example, Sandee et al (2014) present comparative data demonstrating that Indonesian logistics costs are considerably higher – sometimes by a very large margin – than its more efficient neighbours. The authors draw attention to the problems at the country's major port,

[21] Indonesia was not alone in this labour market populism. Similar outcomes, for similar reasons, occurred in the Philippines following the overthrow of the Marcos regime in the mid 1980s. Minimum wages have also increased significantly in Thailand in recent years. See Aswicahyono and Hill (2014b) for ULC estimates for Indonesia compared to its neighbours.

Tanjung Priok, where throughput doubled over the period 2007-13, but there has been no expansion in facilities: '… for more than 10 years no substantial investments have been made to improve productivity.' For comparative purposes, Figure 11 reports the results from the annual World Bank's Logistics Performance Index (LPI), confirming the fact that, again, Indonesia lags its ASEAN neighbours except for the Philippines.

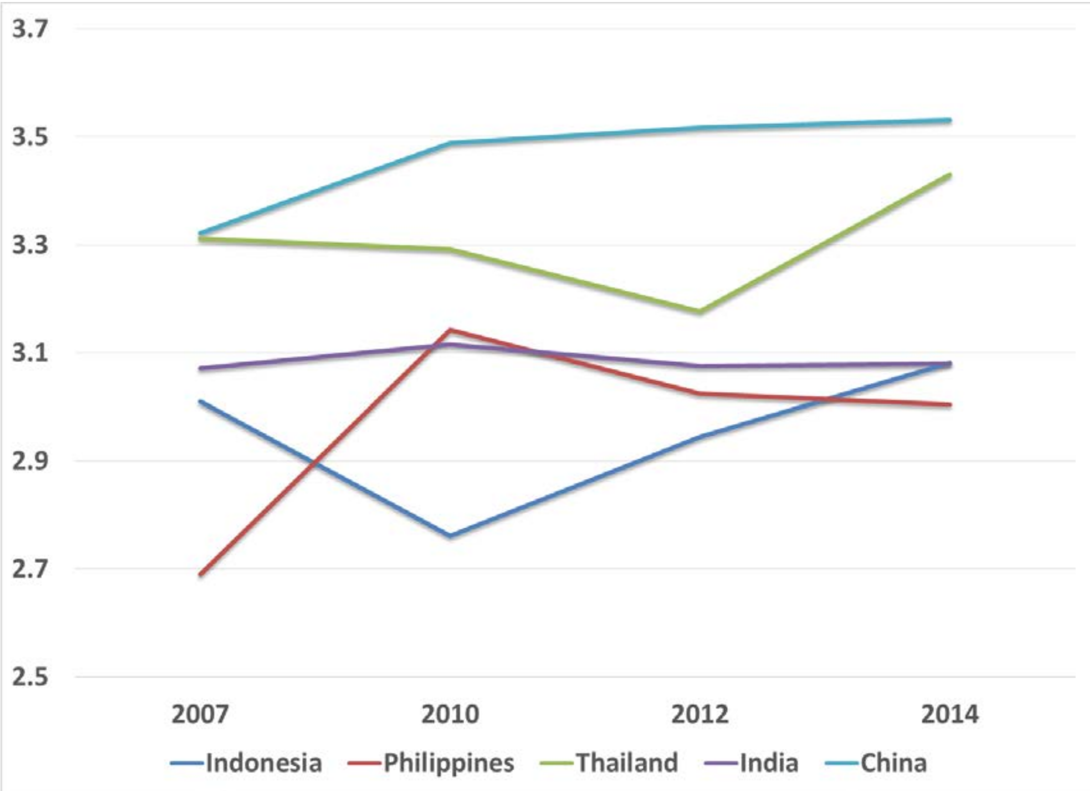

Figure 11: Logistics Indicators, Indonesia and Neighbours

The problems derive from both limited infrastructure investment and regulatory barriers. The under-investment in infrastructure since the late 1990s has contributed to the low quality and quantity of roads, ports, and railways. As a percentage of GDP, Indonesia's infrastructure expenditure is about half of that of both the Soeharto era and high-growth East Asian economies. Regulatory constraints on competition and efficient service provision compound the problems. The contrast with the successful deregulation in air transport and the lack of reform in shipping is striking. In fact, the 2008 Shipping Law introduced cabotage principles that limit the movement of cargo between Indonesian ports to Indonesian flagged vessels. The various master plans and blueprints lay out a strategy to improve connectivity. The question is whether they will be able to address crucial bottlenecks, such as the lack of coordination between local and central governments, the continued domination of state enterprise providers and regulators, and the uncertain commercial environment for potential private sector providers.

With regard to funding, the government's development expenditures were severely curtailed in the wake of the AFC, and the government's fiscal space continues to be highly constrained. At around 14% of GDP, the government's tax effort is rather weak. On the revenue side, more than 30% of allocations pass through directly to local governments, while until recently subsidies absorbed about 20%, a figure that is now likely to fall but in all likelihood will continue to exceed 10%. Personnel, overheads and debt service, all relatively inflexible items, together absorb more than 30% of the total, while all levels of government are required to meet the 20% education target.

Moreover, strong post-AFC aversion to foreign borrowings has meant that successive Indonesian governments have not availed of much of the long-term concessional finance potentially available to it. Decentralization to inexperienced local governments introduced additional problems of coordination and assignment of responsibility. Land acquisition has emerged as a serious constraint in newly democratic local communities intent on redressing past grievances. Private sector infrastructure suppliers are hesitant to invest owing to the resistance to setting prices at levels that would make such investments economic. The bitter experience of many foreign infrastructure providers during the AFC has deterred investors (Wells and Ahmad, 2007). There is also considerable resistance to infrastructure deregulation, principally from bureaucrats and state-owned utility providers who would lose their rents in a more deregulated market.

d. Building Institutions

From a longer-term perspective, Indonesia is in the early stages of establishing a democratic consensus around the institutions needed for a prosperous, equitable and internationally oriented economy. Institutions are complex mechanisms for establishing accepted 'rules of the game', the more so in a young, highly fluid democracy like Indonesia. Generalizations are at best hazardous, and we therefore briefly survey various aspects of institutional development in the country during the democratic era.[22]

Macroeconomic policy:

A legacy of the disastrous macroeconomic policy making under President Sukarno (1945-65), particularly the hyperinflation episode of the mid 1960s, was that macroeconomic management since then has been reasonably effective. Apart from a brief period of very high inflation in 1998, the result of fiscal expansions in support of an open-ended bank recapitalization program being monetized, inflation has been moderate, although consistently higher than its low-inflation neighbours. Again with the exception of the AFC period, fiscal policy has been prudent. Importantly, effective macroeconomic policy making has been maintained during the transition from authoritarian to democratic rule. During the Soeharto era, the government operated what it called a 'balanced budget rule', under which its spending was constrained to the total of domestic revenue and foreign aid. The central bank, Bank Indonesia (BI), operated essentially as an adjunct to the Ministry of Finance, with a fixed but adjustable exchange rate setting designed to ensure international competitiveness.

As part of the controversial LOI with the IMF, BI was granted full operational autonomy in 1999, and over time it instituted a conventional regime of inflation targeting and a floating exchange rate. There is now broad political support for the notion of an independent central bank, and BI's performance has improved over time. The major fiscal policy challenge in the wake of the AFC was to control government debt, which had ballooned dramatically to about 100% of GDP in 1999. An overriding priority was to quickly exit the loathed IMF program, which was implemented in 2003 with the enactment of a fiscal law. This was essentially modeled on the Maastricht principles of deficits not exceeding 3% of GDP and public debt of less than 60% of GDP. Unlike the EU, Indonesia has stayed well within these limits. Combined with modest sales from the nationalized distressed assets, public debt has fallen sharply since 1999, and is now about 25% of GDP. This is an impressive fiscal consolidation. Challenges remain, but overall macroeconomic policy, and the institutions that underpin it, must be counted as a

[22] Some of our thinking on these issues is developed in more detail in Aswicahyono et al (2009).

major success, illustrated most recently in the country's effective response to the GFC.[23]

The legal system:

The legal system is in transition from being a subservient arm of the executive, as it was in the Soeharto era, to a powerful and independent institution designed to protect citizens and property rights. This is a long-term process, that will take decades rather than years to accomplish. But in the institutional vacuum that was created with the collapse of Soeharto, the judiciary is now expected to resolve highly complex issues, ranging from deep-seated commercial disputes, especially those involving land ownership, to a wide range of civil liberties. In this new environment, the quality of judicial appointments is highly variable. Bribery and the 'purchase' of court decisions are evidently quite common. Commercial cases have unpredictable results, with a tendency to favour domestic over foreign firms, and debtors over creditors (Butt, 2009). These outcomes are not surprising. Building up a high quality judiciary is a complex, lengthy and expensive process.

One significant achievement in building effective legal infrastructure has been the KPK, Komisi Pemberantasan Korupsi, Corruption Eradication Commission. The KPK is the most respected institution in the country according to various opinion surveys, and generally regarded as the most effective organization of its type in ASEAN. Established in 2002, it has the authority to investigate and prosecute cases of more than Rp 1 billion (about $70,000 at the time of writing), and involving members of law enforcement agencies and other state officials, as well as parties linked to them. Its powers are extensive, including being able to tap telephones, ban overseas travel, freeze bank accounts, and obtain information from financial institutions. It does not require presidential authority to commence investigations, and it has the authority to appoint prosecutors. It also has the power to take over investigations from the police and the attorney general's office. Most assessments of its operations are positive.[24] One indicator of the KPK's success is the increased

[23] Until recently, Indonesia's macro policy makers have also had responsibility for supervision of the financial sector. Here too they have achieved much, rehabilitating it after the collapse of 1997-98, navigating the GFC, and developing new modalities to cope with global financial volatility. The sector needs to be deepened and strengthened, and its financial safety net provisions remain precarious, but the overall record to date is an impressive one. For a recent authoritative review, see Grenville (2015).

[24] See for example the conclusions of Crouch (2010, p. 228-9): 'The KPK … soon began a series of prosecutions that, although limited in number, obtained significant high-profile

hostility towards it from within the parliament and bureaucracy in recent years. However, public opinion has so far acted as a safeguard in preventing attempts to weaken its authority.

Bureaucratic reform:

Nevertheless, on most comparative rankings of corruption, Indonesia continues to score poorly. One explanation is that the KPK is by definition addressing the symptoms of corruption, not its fundamental causes. This is illustrated in the case of the bureaucracy, where there has yet to be any significant reform during the democratic era. Its remuneration structures remain highly complex and opaque, and also uncompetitive at senior levels. There is a weak link between performance and reward. There is little inter-agency mobility, let alone external recruitment. The opportunities for training and other types of long-term professional development are limited (see McLeod, 2005). Moreover, SOE reform has proceeded very slowly. There is powerful resistance to divesting them, even though it is well known that they are highly politicized and inefficient. One hopeful exception to these generalizations is the small number of agencies that are given greater staffing autonomy in exchange for clear performance mandates. Bank Indonesia is the most important of these agencies, and as noted above it is evolving into a competent, professional organization.

Local-level governance:

Indonesia was a highly centralized state under Soeharto, with little scope for local authority and autonomy. Then in a dramatic initiative, in May 1999 the government announced a 'big bang' decentralization, to take effect from January 1, 2001. The scheme was radical in its intent, with major revenue and administrative authority being passed down to the sub-provincial levels of government, the kotamadya (municipalities) and kabupaten. The fear of territorial disintegration, involving Timor, Papua, Aceh, Maluku and other outlying regions was a key motivation for the hasty action. The reforms were accompanied by democratization, with direct elections for local leaders as well as the assemblies. As a result, Indonesia now has elections for its 530 or so (and counting) provincial and sub-provincial

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convictions. … The convictions obtained by the KPK brought about a dramatic change in the atmosphere and provided a deterrent that had been largely absent in the past.'

authorities. In 2014 the government extended this sub-national architecture by introducing direct grants to the country's 73,000 villages. This decentralization has more or less 'worked', in the sense that the nation's territorial integrity has been preserved, and the functions of government have been maintained. But major challenges remain, in the proliferation of sub-provincial jurisdictions, in coordinating these many local governments, in the highly variable quality of local governance, and the tendency for these local governments to spend on administrative enlargement at the expense of much needed infrastructure and other local services.[25]

4. Conclusions

We have argued that Indonesia is not in any sense 'trapped', as it continues to achieve moderately strong economic growth. Looking forward, if it maintains its current unspectacular but steady growth trajectory, it can expect to lose its comparative advantage in labour and resource-intensive activities, and to graduate into the ranks of the upper middle-income group of countries, and eventually the high-income club. However it has not grown as fast as some of its neighbours, and the growth rate over the past decade and half is slower than that of the three decades of Soeharto rule.

These outcomes, both the moderate success and a growth performance falling short of East Asian frontiers, can be explained through recourse to conventional economic and political economy factors. That is, its growth can be explained by reasonably good macroeconomic management, moderately open trade and investment policies, political stability for most of the past half century, broad-based social progress, and positive neighbourhood effects. But in section 3 we highlight four sets of factors that are constraining growth: the continuing ambivalence towards globalization, low education achievements and poor labour market performance, the major underinvestment in physical infrastructure, and the need to develop a set of high-quality institutions that will deliver much better governance at national and local levels. How future governments are able to address these four sets of factors will significantly influence the speed at which Indonesia is able to graduate from middle to high-income status.

[25] See the chapters in Hill (ed, 2014), particularly Blane Lewis, for detailed discussion of these issues.

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