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Reform in an Imperfect World: the case of Indonesia [1]

M. Chatib Basri

University of Indonesia

I. Introduction

Reform is a word often used in economic policy, a veritable mantra to solve economic issues in many countries. Almost all economic policy recommendations cite the importance of economic reform, and it must be noted that economic reform has brought significant economic change to several countries, as it has in Southeast Asia. In Indonesia, economic reforms undertaken in the mid 1960s and 1980s succeeded in increasing economic growth, improving prosperity and welfare, and decreasing poverty levels. Similar results can be found in Vietnam, the Philippines, Singapore and other Southeast Asian nations. Because of this, reform is thought to be an important part of a nation's economic improvement efforts. As a result, almost all policy recommendations by multilateral institutions or economists include reform.

While economic reform is considered a solution to economic woes, the fact is that it is often difficult to implement. Economic theory provides the theoretical framework to explain why reform must be undertaken and how it impacts the economy. But, economic theory does not provide much advice on how it should be implemented, nor any practical guidance on how to ensure that reforms are workable and successful, especially within the framework of political constraints or in less well-established institutions (Hill, 2013).

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Further, not all reforms succeed, and in fact many fail. When economists are asked why reforms fail, they usually blame politics or institutions. Economists must realize that reform does not happen in a vacuum; rather they must consider the existing political conditions and the constraints that institutions face. The President of the European Commission Jean Claude Juncker asserted, "We all know what to do, we just don't know how to get re-elected after we've done it".[2] Juncker is right, when considering economic reforms, one must also consider their effects on electability. If the political costs of reform are too high, there will be little political support. This implies that there is no 'one size fits all' policy for reform, as the political structures and institutions in each country differ.

Andrews (2013) argues that many economic reforms or institutions fail because the international best practices do not fit the political institutions in developing nations. Given these conditions, economists do not have the luxury of working in a vacuum in which they can ignore political factors and institutional constraints. Rather, economists must live in the political reality. If political factors are not considered, there is a risk that reform will fail or not have political support. Thus, it is vital to study how reform can be effectively implemented in the real world. Unfortunately there are very few such studies available, especially on developing countries. To fill the gap, case studies are needed. This paper will focus on how to implement reform within the existing political and institutional constraints in Indonesia.

Indonesia is the one of the best laboratories to study economic reform, as its government has undertaken a number of reform efforts. Some have been successful, particularly first-generation reforms, like deregulation and trade liberalization in the 1980s (Naim 1994). Others have been very slow, particularly second-generation reforms, like those related to bureaucratic reforms and improvements in public services. Indonesia is a relatively young democracy, with a large population, dynamic politics and strong special interest groups. Further, as a member of G-20, Indonesia has great potential to become one of the major world actors. Indonesia also offers a chance to study how a reform is implemented in "second best world" conditions, as

[2] http://www.telegraph.co.uk/news/worldnews/europe/eu/10967168/Jean-Claude-Junckers-most-outrageous-political-quotations.html

its institutions are not well established and there are strong political and institutional constraints.

This paper will discuss how reform is implemented in an imperfect world or second best world, in which reform should be implemented under political and institutional constraints. Further, it will examine how an implemented reform can be institutionalized. The paper will focus on three case studies: implementing reforms during bad economic times, namely the 2013 Taper Tantrum (explained in section 4); endogenous reform to promote investment in Indonesia in the Investment Coordinating Board, and, third: endogenous reform in Indonesian Customs to reduce dwelling time. This paper combines theoretical approaches with field implementation to enrich our understanding of reform implementation.

The paper is organized as follows: after the introduction, the second section will give a literature review. The third section focuses on the political setting in Indonesia; the fourth deals with the three case studies in Indonesia; while the final section gives a conclusion.

II. Literature review

Before delving into the case studies, it is necessary to discuss what is meant by reform. Hill (2013) defines reform as:

“[I] define “reform” for these purpose as a durable and significant policy change that improves aggregate socioeconomic welfare, consistent also with an objective function that recognizes distributional and environmental considerations.” (Hill, 2-13, p.109)

In this paper, Hill (2013) stresses the importance of concern for general welfare and public interest rather than vested interest and underlines the importance of the words “durability” and “significant”. Reform can also inform the policy making process, by making it more transparent (Hill, 2013), so it is not limited to policy outcomes.

Hill's definition (2013) is a good point of departure for discussing economic reform. While I agree with this definition, it must be noted that reform is a dynamic process, and thus any significant understanding must be viewed in a context that is dynamic and not static. One goal of long-term reform is to improve institutions, but institutional change cannot be accomplished in the short-term. Further, in a democratic nation, politicians are constrained by time – namely the election cycle. The political cycle, which holds elections every 4-5 years, makes politicians reluctant to implement long-term reforms. Oftentimes, significant reforms require long periods of time to show results. As such, reforms must be seen in a dynamic context, in which they are often piecemeal and effected gradually.

The political cycle is also important to examine. Often politicians ask why would they enact long-term reforms if their successors will reap the benefits. There are simply insufficient incentives for politicians to engage in long-term reforms. Of course it can be argued that statesmanship and leadership are needed. That is the ideal. But in reality, we do not always have ideal leaders who possess extraordinary statesmanship.

Reform can start with insignificant, or even easy, steps, to create a success story, which can then be used as a stepping-stone to more difficult and complex reforms. It is crucial to have a success story, as these help policy makers gain political support and political credibility. Hill (2013) mentions that reform can be done as large-scale or incremental.

Many studies exist which classify and define reform. Naim (1994) categorizes reform in two parts: first-generation reform which includes macroeconomic stabilization, tariff reduction, budget cuts, privatization, etc., followed by second-generation reform which is broader, covering bureaucratic reforms, efforts to improve public services and human capital. Naim (1994) claims that first-generation reform focuses on policy instruments, while second-generation reform stresses desired outcomes like better public services. Second-generation reforms tend to be more complex as they are strongly tied to institutional changes and development, and thus more difficult to implement or achieve.

As previously mentioned, reform is highly complex. As such, to achieve reform, there are several items demanding attention, which are outlined in the general guidelines of political economy theory.

Political economy of reform[3]

Rodrik (1998) takes the approach that success in economic reform depends on how these reforms are beneficial or detrimental to interest groups. This is known as Distributive Consequences among interest groups. This approach is concerned with the distributional impact of economic reform, for example in the case of trade reform. Support for, or objection to, trade reform is determined by the distributional impact among various interest groups. This approach argues, for example, that the politics of trade liberalization usually focuses on the conflict among interest groups attempting to increase their share of national income. In other words, trade liberalization is closely associated with income distribution (Rodrik, 1998). The standard framework for explaining the impact of trade liberalization on income distribution is drawn from the Stolper-Samuleson theorem and the specific factor hypothesis.

The distributive consequences framework argues that some groups will be hurt by trade reform and so will oppose it, while other groups will benefit and so will support it. This complicates the trade liberalization process. Therefore, from the policy makers' viewpoint, the pure reallocation of income should be considered a political cost. While, on the other hand, the efficiency gain from reform should be considered a political gain.

In an extension of this approach, Edwards and Lederman (1998) classify users of imports into users for domestic purpose and users for export. Consumers of imported goods and exporters are usually amongst the early supporters of trade reform, since they directly benefit from it. Exporters also benefit from the exchange rate depreciation that usually takes place in the early stages of trade reform. Producers of import competing goods generally resist trade reform but are at least partially compensated by the exchange rate depreciation (Edwards and Lederman, 1998). Corden (1997) also argues that, if the real exchange rate does not change and

[3] This is partially drawn from Basri (2001)

total real expenditure stays constant, the reduction in import protection will shift demand towards imports while the output of import competing industries will decline and the current account will deteriorate. These effects will create pressure for the rejection of trade liberalisation. In other words, Corden (1997) is saying the exchange rate must either be devalued, or allowed to depreciate sufficiently. The implication is that trade liberalization should normally be a part of a policy package which includes adequate depreciation.

Although the distributive consequences framework can help to configure the winners and losers from trade reform, it has its own limitations. As Rodrik (1998) admits, by its very nature, trade liberalization creates a lot of winners whose identity cannot be predicted prior to the reform. For example, after a medium or even a long term, some import competing industrialists could transform themselves into export-oriented industrialists, and eventually support the reform. Rodrik (1998) argues that the full configuration of winners and losers only becomes apparent after the reform takes place. Subject to its limitations, this analytical framework could help give a brief picture of winners and losers from trade reform but is silent about the trigger. So, in order to get a better perspective of the trigger factors, the distributive consequences of trade reform should be combined with the "crisis" hypothesis introduced by Bates and Krueger (1993).

This approach argues that economic reform, including trade reform, is initiated by an economic crisis. Krueger and Bates (1993) argue that a crisis is probably the most powerful stimulus for reform. However the degree of crisis sufficient to initiate reform can be unique for each country. When a crisis is the trigger, the policy change can be driven either because earlier policies are perceived as having failed or because exogenous events, such as a worldwide recession, are blamed for events which, in turn, demand policy change. Furthermore, the "crisis" hypothesis argues that, in the midst of an economic crisis, the role of social scientists becomes increasingly important, as they are consulted by politicians to help forge a way out of the crisis (Edwards and Lederman, 1998).

Although there is some truth to this hypothesis, Williamson and Haggard (1994) produce a more cautious conclusion that a crisis is neither a necessary nor sufficient condition to initiate reform. Nevertheless, it is true that a crisis has often played a critical role in stimulating reform. This argument has been concluded in some country cases, including Australia and Colombia, where a crisis seemed to play no major role in motivating a reform effort. In the case of Australia, Garnaut (1994) points out that a new government initiated reform. While it is true the Australian government used a crisis atmosphere to advance reform, the shape of the reform was determined more by the initiative of the new government than the crisis itself (Garnaut, 1994). Similar to Australia, economic liberalization in Colombia was not preceded by an economic crisis, but by government initiative. In this case, the outgoing government decided to commence reform, with the support of the incoming administration from the same party (Williamson and Haggard, 1994). In addition, Rajapatirana et.al (1997) share a sceptical view of the “crisis hypothesis”. They argue that trade tightening has been the immediate response to some macroeconomic crises in Latin America. The reasons being that the macroeconomic crises were associated with high inflation, which led to an appreciation of the real exchange rate. This in turn led some governments to tighten their trade regime.

As for Southeast Asia, Hill (2013) provides an excellent survey on the political economy of reform. Hill (2013) shows that there exist some similarities in reform patterns, primarily that there must be support for reform. This can come from groups that have the desire to run for public office, or groups that want to work with political leaders. In the case of Indonesia, this group is often associated with technocrats or the liberal epistemic community (Hill, 2013; Basri, 2001, Mallarangeng 2001). In addition, political leadership is also an important factor. External factors, like economic crises, negative exogenous shock or problems with existing systems also encourage reform. Hill further shows that reform is sustainable if it has political support. Institutions also play an important role. This is not to say that reform can only be done when existing institutions are strong. Rather, Hill makes the point that if well-established institutions can only implement the reform agenda, reform will be extremely difficult to implement in developing countries. Developing countries must wait for their institutions to mature before conducting reform. Thus, this paper addresses how to work within such institutional and political constraints. This approach is extremely important, as the reality is that in many developing nations, institutions remain less established, and political constraints make it difficult to implement reforms at the standard of developed nations.

PDIA and Endogenous Reform

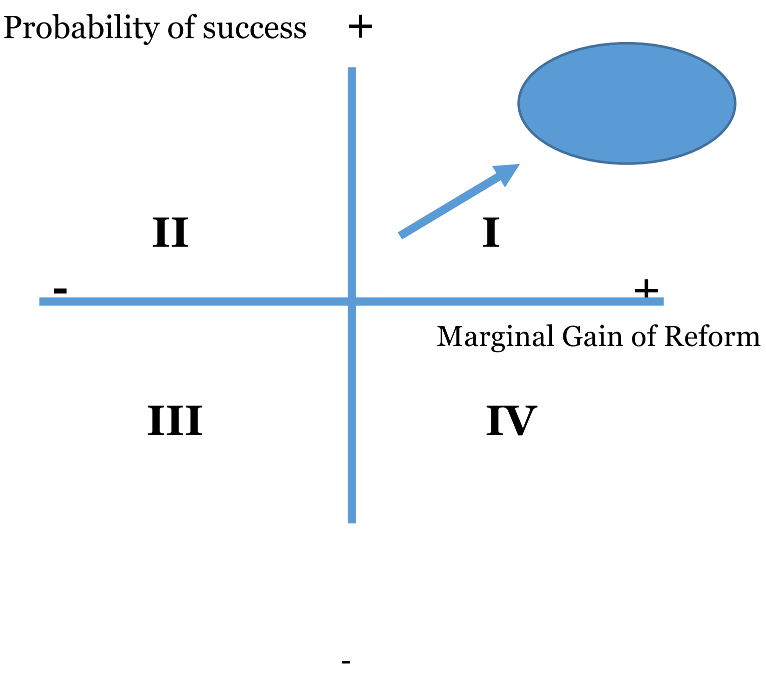
Andrews (2013) introduced the Problem Driven Iterative Adaptation (PDIA) method. At its core, PDIA identifies problems and then takes experimental steps to obtain quick wins. It studies and evaluates these to develop the capacity and support for reforms. This process is conducted iteratively. While this approach does take time and requires experimentation, the reform process will fit within existing conditions and garner wider support. The PDIA approach is both highly appealing and the most applicable for policy makers. With modifications and flexibility in its implementation, PDIA can assist in making reform a reality.

It is important to recognize that there are limited resources for reform, both in terms of financial and political support. A policy maker like a technocrat does not always have full political support. As such, a policy maker must prioritize how political leaders can support reform. Further, policy makers do not always have the luxury of time, due to political cycles. Thus, reforms must be undertaken in relatively short time frames within the framework of existing resource constraints. So a continuous process which results in quick wins or success stories is vital. The success of a reform often depends not on how good or bad the reform agenda is, but rather the political support to continue the reform. This means that reforms must be endogenous to ensure sustainable political support.

The dilemma is that in reforms the cost is immediate but the benefit is often in the long-term. Thus, quick wins are needed to gain political support. Reforms that are only focused on long-term issues and which ignore political cycles will be difficult for politicians or leaders to support.

Given these conditions, the strategy for reform can be illustrated as below:

Figure 1: Strategy for Reform



In the graph above, we can find four quadrants, in which in Quadrant I, the marginal gains are relatively high as is the probability of success. It is crucial to create success stories, so that reform is easy to implement and has a relatively large impact.

Success stories help to increase the credibility of policy makers. Through success stories, the general public feels the impact, even if it is only limited. For a policy maker, success stories increase credibility and political capital, resulting in increased political support for future reform. Further, support from the general public gives an incentive for leaders to undertake reform. This process is iterative. It starts with the simplest of reforms with the simplest of targets, moving on to more complex reforms with more complex targets, and thus builds into an endogenous reform process.

III Indonesia: The Limits of reform, a political economy landscape

Political landscape

Before delving into the Indonesian case studies, it is important to first understand the Indonesian political system. In the current system, the people directly elect the Indonesian President. At the same time, the people vote for members of parliament. Indonesia has a multi-party presidential system. This has consequences on policy. In a presidential system, the President holds executive power, but the political parties dominate both legislative houses, and the president's party has thus far not enjoyed a majority (Basri and Hill, 2011). As a result, although it is a presidential system, the President's powers are limited as he must compromise to garner support from varied political parties in enacting laws in parliament. Thus, political parties dominate. To achieve strong political support from the legislature, Susilo Bambang Yudhoyono (SBY) formed a "rainbow coalition" in his cabinet. President SBY realized that his cabinet could not be solely based on meritocracy and filled with technocrats, as he had to consider political equality. Given this political background, the success of economic reform is highly dependent on political support from a variety of actors. President Joko Widodo took the same approach. When he first came to power, he did not form a "rainbow coalition" and political support in the legislature was only 37%. Several political obstacles arose, particularly from opposition parties, which led President Joko Widodo to take steps to enlarge his coalition to include 69% of the political parties in the legislature (Warburton, 2016). Needless to say, in return for the rainbow coalition, President Widodo altered the composition of his cabinet, giving positions to members of several political parties that had previously been excluded, like Golkar and PAN.

It is important to know that the President and Vice President can only be elected twice, to five-year terms in Indonesia, for a total governance of ten years. This means that the political cycle is five years. Long-term reforms are not attractive, unless the President is elected to a second term. These cycles are crucial, as politicians are reluctant to sacrifice their political capital if the results will be enjoyed by their successor.

Taxonomy of economic reform in Indonesia

Table 1 shows the taxonomy of the political support for economic reform. Here reform means the application of basic economic principles like minimalizing market distortions, opening trade and investment regimes to increase productivity, fostering competition and expanding the market economy. In this context, the "most reliable" proponents of economic reform are the technocrats. In Indonesia, the term 'technocrats' was first used to refer to the group of economists employed to help Soeharto with economic policy. Most were from The Faculty of Economics, University of Indonesia (FEUI) and had advanced degrees from abroad, mainly the United States. Originally they consisted of the five following men: Widjojo Nitisastro, Ali Wardhana, Emil Salim, Mohamad Sadli and Subroto.[4] The group evolved over the years to include a non-partisan group of professionals in the cabinet who were recruited for their professional skills. Although the technocrats have changed greatly since the Soeharto era, the economic ministerial posts, particularly in the Finance Ministry, continue to be held by non-partisans with deep understanding of economics. It is important to note that in line with the development of democracy in Indonesia and the "rainbow coalition" phenomenon, the number of technocrats in the cabinet has become increasingly limited. Further, these technocrats do not have strong political support, as they do not rise through the ranks of political parties.

How about the role of politicians, bureaucrats, the media and civil society in pushing economic reform? Politicians tend to maximize their political interest. Acemoglu, Egorov and Sonin (2013) point to the tendency of politicians to promote populist policies, which are widely supported by the majority, but are at odds with economic rationality. The attitudes of politicians are often ambiguous. They support economic reform if it strengthens their position. Unfortunately, all too often economic reform is unpopular and politicians naturally shy away from unpopular policy. As mentioned above, one dilemma in economic reform is that often the sacrifices are immediate, while the benefits will only be enjoyed in the mid- to long-term. Thus, there is a tendency for politicians to reject economic reform in the short-term. It is understandable that politicians would rather focus on maximizing short-run political support, as they are conscious of the five-year election cycle. Why should they support policies that will only pay off after they are no longer in office? In Indonesia this can be seen in the resistance to unpopular policies, which are vital to the economy, like the decrease in the fuel subsidy or trade and investment liberalization.

How about the bureaucracy? In Indonesia, Ministers and Presidents come and go, while career bureaucrats remain. As such, they tend to maintain the status quo. They implement the policy set by political leaders. While it is true that there does exist a spirit to further encourage economic reform, this group is quite limited. The majority

[4] For a review of the role of technocrats, see Brooks, 1997.

is happy with the status quo and worry that economic reform will cost them by lowering their power and reducing the potential to earn "extra income".

Media and civil society in Indonesia unfortunately are widely divided on the issue of economic reform. There is a tendency to reject a wider market role as popular ideology posits that giving a larger role to markets or trade and investment liberalization is the goal of global capitalism. Finally, one cannot ignore the political interest of media owners, who themselves may be hurt by trade reform through their business networks.

Nevertheless, it must be noted that the media and civil society are important proponents of eradicating corruption and improving institutions, and support reforms in these areas.

Given this background, we can understand why economic reform is so difficult in Indonesia. There are a limited number of technocrats and these have limited support. In general, technocrats play an important role in shaping reforms when crises occur. When a crisis hits, politicians give technocrats the room and support to improve conditions. But in good economic situations, politicians are reluctant to sacrifice their political capital by adopting unpopular policies, even if they are vital in the long-term.

This background helps us understand why economic reforms are so often difficult to implement. This is only expected to worsen, as the role of technocrats shrinks, unless technocrats learn how to take advantage of political parties.

Table 1: Taxonomy of Economic Reform in Indonesia

Actors	Stance on economic reform
Technocrats	Pro-reform, but limited in number and lack political support
Politicians	Will push reform as long it does not jeopardize their political support (tend to support populist policies)
Bureaucracy	Tend to preserve status quo
Media	Strong political interests
Civil Society	Support reform, but tend not to support the "market approach based reform" for ideological reasons.

Adopted from Basri and Patunru (2012)

Needless to say, Table 1 simplifies the issue and it is worth noting that there is not always a clear distinction between each contending group. Furthermore, the views of contending groups also need to be understood in terms of the time period, owing to the dynamics of change in the political sphere and to economic conditions (Basri, 2001).

In certain situations politicians will form coalitions with technocrats, even though this can endanger their political capital. For example, politicians might sacrifice their political capital just after their election, when their political capital is still strong, or during crisis situations, like when Jokowi abolished fuel subsidies at the start of his term. Further, in this taxonomy, it is assumed that the motor for reform are the technocrats, but this is not always true, as certain reforms can also be pushed by ideas outlined in political campaigns or pressures from civil society or the media which aim to improve public services, for example. With such limitations, the Taxonomy outlined in Table 1 should be taken with these qualifications in mind. While Table 1 does have several weaknesses, it helps map the main actors in economic reform in Indonesia.

As mentioned previously, a reform's success is also determined by political capital and there are limited resources for reform. Leaders will not give unlimited political support to technocrats; budget limitations apply, as do time pressures.

Given these considerations, it is important for reform to be undertaken in stages, to create success stories, and then capitalize on these successes to attain greater credibility and political support for reform. This credibility and political support will help to increase the political capital to undertake more complex reforms. Each success will allow us to move on to more and more complex and difficult reforms, known as Endogenous Reform. In this way, the constraints and limitations inherent in reform in Indonesia can be overcome and sustainability will be safeguarded. This will be discussed in the three case studies below.

IV. The Three Case Studies

Case Study 1: Decreasing Fuel Subsidies and Abolishing the Imported Beef Quota[5]

In May 2013 Indonesia's economy, particularly the financial sector, was under pressure from the Fed's plans to normalize its monetary policy. After implementing Quantitative Easing (QE) in 2009, in May 2013, Bernanke opened the possibility to end its QE policy (tapering its securities purchases). This became clearer with Bernanke's testimony to Congress on 22 May 2013. This impacted Emerging Markets (EMs), which experienced significant drops in their financial markets and exchange rates, particularly in Turkey, India, Brazil, South Africa and Indonesia, known as the Taper Tantrum (TT). To face these pressures, each country adopted a series of macro-economic policies. Indonesia and India succeeded in overcoming this and untangling themselves from the group of countries known as the Fragile Five,[6] in a relatively short period (about 7 months), stabilizing their macro-economic conditions (Basri, 2016; Basri, 2017).

One concern, particularly by players in the financial markets, is any increase in the current account deficit financed by investment portfolios. Thus, to stabilize the macro-economy, the Indonesian government and Bank Indonesia decided to take stabilizing steps by reducing the current account deficit. This was done by cutting the budget deficit by increasing fuel prices and tightening monetary policy to decrease the current account deficit. Bank Indonesia also allowed the exchange rate to

[5] This case study is heavily drawn from Basri (2016)
[6] Fragile Five was coined by Morgan Stanley (2013) for Indonesia, India, South Africa, Brazil and Turkey, which were at risk after Bernanke decided to end the QE policy.

fluctuate in line with economic fundamentals and market mechanisms. The Indonesian government also undertook a series of structural reforms like abolishing the beef quota and improving dwelling time (both of which will be discussed separately in this section).

Decreasing Fuel Subsidies

A wealth of research show that Indonesia's fuel subsidies were both misdirected and unproductive. Thus, reforms aimed at reducing fuel subsidies by raising fuel prices and allocating these funds to infrastructure, poverty and health programs were an important step. The problem is that these were difficult to implement politically. What was the political economy of the process and how was it possible?

To better understand the impact of fuel subsidies on the Indonesian government budget, it is helpful to examine the budget structure for 2013. In 2013, the government's budget deficit was initially calculated at 1.65%, of which fuel subsidies accounted for Rp 193 trillion ($ 20 billion) or nearly 2% of GDP. But increases in global oil prices and in domestic fuel consumption led the fuel subsidy to swell to Rp 297 trillion ($31 billion) or nearly 3% of GDP at the end of 2013. The increase in fuel consumption volume was due to a rise in demand, as well as fuel smuggling, and the migration of non-subsidized fuel to subsidized fuel. The subsidies swelled, and the budget deficit for 2013 was expected to exceed the 3% maximum deficit allowed by law.[7] Internal calculations by the Finance Ministry predicted that if the government did not cut the subsidies, the budget deficit would bloat to 5%. A large budget deficit leads to an increase in the current account deficit, which in turn causes capital outflow as financing comes from portfolio investment[8] (Basri, 2016; Basri, 2017). Therefore, to improve the current account deficit, it was necessary to decrease the fuel subsidy.

The government cut fuel subsidies by raising the price of gasoline and diesel oil from Rp4.500/liter to Rp6.500/liter and Rp5.500/liter, respectively. The Government Ministry / Institution budget was also cut by Rp24.6 trillion ($2.5 billion).

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[7] The State Finance Act was approved in 2003, which limits the maximum budget deficit to 3%. This figure consolidates the central and regional budget deficits.

[8] Jakarta Post, May, 28, 2013, " Cut Subsidies or Else"
http://www.thejakartapost.com/news/2013/05/28/cut-subsidies-or-else-chatib.html

Increasing fuel prices did not require parliamentary approval, but as a result of the fuel price hike, the government needed to provide a budget for compensating the poor. President Yudhoyono would only agree to the fuel price hike if funds were made available for the poor. These compensation funds were crucial, as the increase in the fuel prices would lead to inflation, which has the greatest impact on the poor through its chain effect on price increases.

The Cabinet's technocrats, with support from Vice President Boediono, submitted proposals to decrease subsidies and increase fuel prices. But Ministers with deep political backgrounds saw this as risky, especially as the policy was taken less than one year before the 2014 general elections. An increase in fuel prices would jeopardize the government's popularity and the popularity of political parties supporting the government. Although President Yudhoyono was in his second term and ineligible to run again, the policy would influence the popularity of his party and other supporters. Heated discussions ensued in the Cabinet, revolving around not only the economics of such a move, but also the political impact and the preparation of compensation for the poor. In the end, President Yudhoyono decided to support the fuel price hike.

Outside the Cabinet, deliberations with the parliament were extremely difficult. Although the data proved unequivocally that the fuel subsidies were ineffective, only benefiting the middle and upper classes, it was not solely an economic issue, as it encompassed political, social and security concerns. In the parliamentary debates, the government's coalition of political parties was not wholly solid. The Prosperous Justice Party (Partai Keadilan Sejahtera or PKS), although part of the government's coalition, opposed the policy. Opposition parties like the Indonesian Democratic Party of Struggle (Partai Demokrasi Indonesia Perjuangan or PDI-P) were strongly opposed and went on the attack, arguing that the budget deficit could be resolved by increasing revenue. The government rejected the argument, positing that the issue was not how to increase revenue to cover the subsidies, but that the subsidies were intrinsically unfair. In responding to the parliament, the government held that even in a budget surplus, the fuel subsidy would have to be decreased and replaced with targeted subsidies for the poor, like direct cash transfers (BLSM), conditional cash transfers (PKH), and infrastructure and health programs.

After a long and heated debate accompanied by street protests, the budget revision was approved in a Plenary Session of the House of Representatives (DPR) on 17 June 2013. On 21 June 2013, the government formally announced the increase in fuel prices.

Abolishing the Imported Beef Quota

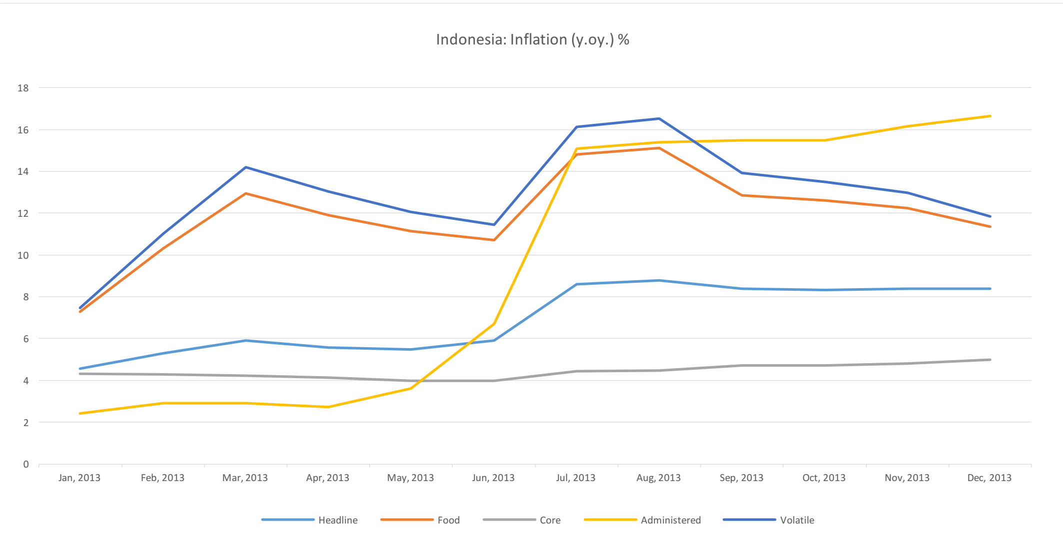
As a direct result of the fuel price hike, inflation rose significantly (Figure 2). This impacted purchasing power, particularly among the poor. To overcome this situation, the government took several steps to decrease inflation. One of these was to change the protectionist beef import system from a quota to a tariff, and lower the import tariff on soybeans to 0%. This was in response to the fact that from July-August 2013 the price of beef and soybeans rose sharply as a result of reduced supply due to import constraints, the weakening of the rupiah and the inflation cycle related to Idul Fitri and the fasting month.

In August 2013, the price of beef soared, to more than Rp 100.000/kg from Rp 75.000-80.000/kg. At the same time, the price of soybeans also rose steeply. One of the reasons cited by the Ministries of Trade and Agriculture was the weakening rupiah. The fuel price hike also certainly contributed to this. To overcome inflation and maintain purchasing power, these price increases were discussed in special Cabinet Meetings.

As in many countries, import protections and quotas are extremely sensitive and involve a variety of political economy issues. There were two main perspectives in the Cabinet Meetings. The first view held that the protection system of quotas was necessary to protect local producers, and that existing mechanisms were sufficient, and simply needed to be better-implemented, mainly supported by the Ministers of Agriculture and Trade. The second view was that the protection system creates problems, and should be removed and replaced with a tariff system, and, in the case of soybeans, the import tariff should be cut to 0%. The proponents of the second view argued that quotas and protections often contain risks like rent seeking activities and result in higher domestic prices. The largest proportion of spending by the poor is on food, and, as such, a decrease in food prices by opening imports and changing the system from quotas to tariffs would increase the purchasing power of the poor. Vice President Boedi0no and the Minister of Finance supported this.

This debate required several Cabinet Meetings, before President Yudhoyono finally agreed to abolish the beef quota and lower the soybean import tariff. The Minister of Trade then issued a regulation that eliminated the beef quota and replaced it with a preferential price system, in which the price of beef was set to below a certain level (Rp 76.000) and the Minister of Finance, in agreement with the Minister of Agriculture, cut import tariffs on soybeans to 0%.

Figure2: Indonesia: Inflation, Jan 2013-Dec 2013



Taken from Basri (2017)

This was an important step in structural reform in Indonesia. As discussed above, import quotas are always a politically sensitive issue and it is extremely difficult to introduce reforms on import quotas. But the urgent economic situation made it possible to introduce more rational economic policy. Figure 2 shows that after the government abolished the import quotas for beef and reduced the duties on imported soybeans to 0%, the price of beef and soybeans could be controlled and food inflation decreased. Of course, the decrease in food inflation cannot be solely explained by these reforms, as it was also due in part to the end of Idul Fitri in August 2013 and the tight monetary policy. The combination of all of these factors controlled inflation to 8.4% through the end of 2013.

The next important question to ask is how could these unpopular policies be adopted? Basri, Rahardja and Fitrania (2016) show that undertaking economic reform in Indonesia is not easy, as the number and support for technocrats, who are economic reform proponents, is extremely limited. Basri, Rahardja and Fitrania (2016) also show that technocrats play an important role in policy during economic crises. In such situations, politicians tend to give the space and support to technocrats to improve things. But, in good economic times, politicians are unwilling to sacrifice their political capital by undertaking unpopular policies, even though these are crucial in the long-term. This explains why these difficult policies could be adopted in 2013, as the economic situation was quite worrying. Politicians are willing to cede to technocrats and adopt unpopular policy stances to save the economy. When a crisis occurs, politicians lose popularity. But, reversely, in stable situations, it is hard to adopt reforms. This was evident after the first quarter of 2014 when the structural reform process slackened and was difficult to continue. Another fuel price increase could not be implemented until the government was elected and in power. This proves the hypothesis of Bates and Krueger (1993), “bad times make good policy and good times make bad policy”.

Case Study 2: Improving the Investment Climate in the Investment Coordinating Board

One way that the Indonesian government strove to encourage economic growth was to attract foreign investment to Indonesia. With limited domestic savings compared to its investment needs, Foreign Direct Investment (FDI) was a necessity. Many studies have shown the positive impact of FDI on the economy, including in Indonesia (Lipsey and Sjoholm 2011; Aswicahyono and Hill, 1995). Although it is widely understood that FDI has a positive impact on the economy of a nation, in practice efforts to attract FDI are often constrained by a variety of factors, from closed investment regimes to bureaucratic red tape. Attempts to change the investment regime are important and significant, as are improvements in the bureaucracy. The problem is that political constraints are often quite severe. Political support for FDI liberalization is usually minimal, due to the strength of vested interests, rent seeking and economic nationalist sentiments. In addition, bureaucratic reform is not easy, as many bureaucratics are loath to see their power diminished. The political capital for reform was limited and not a government priority, like addressing poverty levels, rising fuel subsidies, etc. In addition, time was a limiting factor, as the government cycle would end in two years (this case study occurred in 2012).

In the real world, reforms are not undertaken in ideal institutional or political conditions. Therefore, reforms must be designed to be politically feasible and easy to implement and yet still have a big impact. As previously mentioned, the best way to do this is to create success stories through quick wins and then capitalize on these to gain credibility and political support for more complex reforms.

Improving the investment climate is easier said than done, as obstacles arise from various Ministries, Institutions and regional governments. Further, this requires a serious commitment as it also encompasses improvements in government services and bureaucratic reforms. Given the magnitude of this topic, this section will limit itself to the reform case study in the Investment Coordinating Board (BKPM), as an example of Endogenous Reform.

For this reason, in 2012-2013 BKPM focused on efforts to improve the information system to attract foreign investment. There were several reasons for taking this step. First, there would be no need for regulatory change, and thus the reform process could proceed without approval from the parliament, President or other institutions. Second, this was relatively cheap. And, third, it was easy to accomplish and the results would be quickly evident.

The underlying background for the reform was user experience. The BKPM had to put themselves in the shoes of potential investors. What steps were necessary to invest in Indonesia? Information about Indonesia was relatively limited, particularly related to investment procedures. Thus, many investors would depend on feasibility studies produced by investment consultants or travele to Indonesia to conduct their own field research, both of which are costly for investors. To address this, it was necessary to provide cheaper and better information. The simplest way was through developing a website and a capable Investors Relation Unit. The obstacle often faced by government institutions is that even a simple improvement like this takes a long time due to limited human resources and systems.

It is interesting to examine what the BKPM did to speed up improvements. The first step was to identify how user-friendly the BKPM website was for investors. There was no structure to the information system and thus it was difficult for potential investors to understand the investment process in Indonesia. This finding was consistent with a study by LPEM (2005), which showed that the BKPM permit process was complicated and complex. LPEM (2005) showed that, on average, it took seven weeks for BKPM to approve a foreign investment permit. This was much longer than the official time of just two weeks (10 working days) in 2005 (later accelerated to a maximum of three working days in 2013 and 3 hours in 2016). The extra time, beyond the official time, was partly because BKPM only started counting an application as accepted when it was "complete and correct." Investors often needed to check with a BKPM official to determine what supporting documents and information was required. On average, investor applications were rejected twice prior to the final submission. These findings show that one obstacle to investment arose from information uncertainty regarding documents and procedures. Thus, improvements to the information system make the process easier. This type of reform is simple to implement and has a positive impact. Improving a website, though seen as trivial and unimportant, can actually have a big impact.

Because of constraints in human resources and time constraints, improvements to the website relied on benchmarks against other countries. The World Bank advises benchmarking with Costa Rica, as its website is considered to be one of the very best at providing information. Thus, to accelerate the process, the BKPM website adopted the same structure as Costa Rica. This was relatively easy and fast to implement even given the human resource constraints.

Another step was to improve systems in the Investors Relation Unit (IRU). The Investors Relation Unit plays a crucial role in providing information. But there were several issues. For example, it was often difficult for investors to reach the IRU, and there were no standards for providing information, which in turn often led to confusion. By examining the issues in the BKPM, it became clear that one reason that the Investors Relation Unit was not functioning well was that it was very difficult to reach by phone. The telephone was rarely answered and e-mails rarely replied to! A simple step was taken: the Investors Relation Unit was required to answer the phone and reply to e-mails. To ensure that this was done, all phone calls were recorded and each incoming e-mail and reply was copied to an IRU supervisor. Further, a monthly meeting chaired by the Head of the Investment Coordinating Board was conducted during which a randomly selected phone call between the IRU and an investor was discussed. This method ensured that the IRU was available to provide explanations to investors. In addition, the recordings allowed the BKPM supervisors to better understand what training was necessary to improve the quality of the IRU staff. The BKPM then sent ten staff members to the International Financial Corporation (IFC) to study how to handle investors and get on-the-job training in 2012.

Another benchmark in the permit process was to ensure that the front office comply with the International Organization for Standardization (ISO). This made the investment procedure easier to understand and accelerated the process (which in 2013 was set at a maximum of three working days). Currently the permit process can be completed in just one day, or even a few hours. This is a small example: reform through requiring the IRU to answer the phone. But the result is significant. Investors can see the change and this small change improves the credibility for more complicated and complex reforms.

Another obstacle in the investment permit process was uncertainty, as the investment permit process resembled a black box, in which investors could not understand the process, and could only hope that their application would be approved. In a good bureaucratic system, a “black box” might not be an issue, but in a system in which the bureaucracy still needs to be improved, this creates uncertainty for investors. To make the investment permit application process more accountable, BKPM created an online tracking system for investors to monitor the process. In this system, investors are given a PIN (Personal Identification Number) after applying for an investment permit and can use this to monitor the permit licensing process. Investors can see the status of their application and know which unit is processing the application. If they see that no progress is being made, they can e-mail the Head of BKPM. The Head of BKPM can then contact the deputy responsible for the application. This online tracking system is a simple way to increase certainty. Every day, 500-600 investors use this online system to track their applications.

This small step became a conversation piece for investors, who could see a real positive change. To capitalize on this, the online tracking system was publicized in the media.[9] As a result, this positive news story spread, increasing the credibility for further reforms. The World Bank became interested in providing further support to the BKPM, as it had shown real potential to become one of the champions for reform programs in Indonesia. The online tracking system also attracted the attention of other government agencies, including President Yudhoyono, who sought to implement a similar system in the Presidential Palace. This case shows that creating success stories is vital. As mentioned previously, success stories increase the credibility for reform in the eyes of policy makers. Through success stories, civil society can feel the impact of reforms, even if limited. For policy makers, these success stories help foster political capital, and thus policy makers who enact reforms will have greater political support from leaders. Civil society also supports these changes, giving further incentive to leaders. This is an example of Endogenous Reform, and the process can be done iteratively. A simple reform can slowly blossom into far more complex reforms and changes. Endogenous Reform is consistent with the PDIA put forth by Andrews (2013). The online tracking system later evolved into the one-stop service program adopted by BKPM under President Joko Widodo.

It is also interesting to note how regional bureaucratic obstacles can be overcome. Under Indonesian Investment Law, regional governments have the authority to grant regional permits. By granting this authority, the central government can no longer control the regional governments. Of course this autonomy is good, but it has the inherent risk of leading to a principal agent problem, in which the agent (in this case

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[9] Indonesia Investment Authority BKPM Launches New Online Tracking System http://jakartaglobe.id/archive/indonesian-investment-authority-bkpm-launches-new-online-tracking-system/ ; Tempo, Tempo BKPM Launches Online Tracking System https://nasional.tempo.co/read/news/2012/10/24/055437634/bkpm-launches-online-tracking-system ; Jakarta Service, 2012 Investment in Indonesia Top $32 billion a Record http://www.jakartaservice.com/2012-investment-realization-in-indonesia-may-top-31-billion-a-record/

the regional government) can disobey the principal (the central government). As the central government cannot penalize or reward regional governments, the investment process varies greatly from one region to another. In regions with strong regional heads, the investment process is easy. But, in regions where the leaders do not support simplifying investment procedures, investors face many obstacles. To overcome this issue, BKPM strove to identify regional champions. Through road shows and promotions, BKPM advised investors to prioritize regions with proven good governance and conducive investment climates. BKPM also encouraged regional heads to join these road shows and meet with investors directly. In addition, BKPM gave awards to regions with the best investment climates based on surveys conducted by independent researchers. This enabled regions to see the real rewards in improving their investment climates.

The examples above demonstrate how a reform process can start small, create success stories that can then be replicated in other places and foster credibility gains that can be used to promote more complex reforms.

These measures have had a real impact. Investment in Indonesia has increased significantly, peaking in 2012, during which gross domestic capital formation (investment) grew by 9.8%. Of course, this was not solely due to the reforms undertaken by BKPM. The most important factor was the capital inflow resulting from the Quantitative Easing policy in US. Anther influential factor was the strong optimism in Indonesia that the economy would continue to grow and become the 7th largest economy in the world, if reforms aimed at increasing productivity continued, particularly related to improvements in infrastructure (McKinsey, 2012). This optimistic view was not only held by the Indonesian government, as the Asian Development Bank (ADB) stated that the high investment growth was supported by improvements in the investment climate, the record of strong economic growth over the last several years, and credit increases. IMD (2013) also shows that Indonesia's ranking in World Competitiveness increased to 39 in 2013, from 42 in 2012. With these small steps, several of the problems identified in the LPEM (2005) could be overcome.

Case Study 3: Reforms to Reduce Dwelling Time

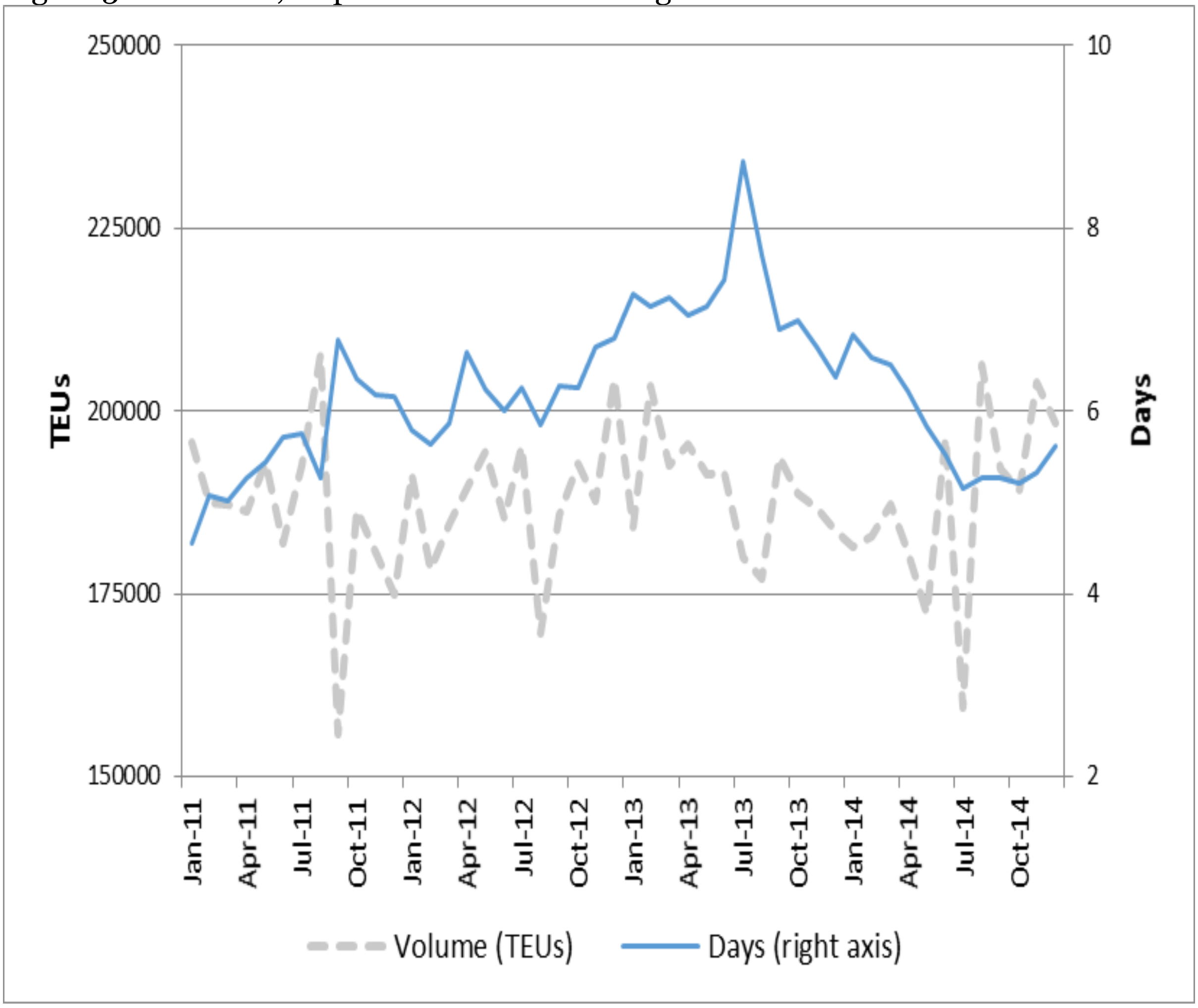
Dwelling time is one issue that negatively impacts the flow of goods. Dwelling time has long been an issue in Indonesia, as the complicated bureaucratic process and infrastructure constraints lead to very long dwell times, resulting in extremely expensive logistics costs in Indonesia (Sandee, 2016). An LPEM survey from 2005 pointed to several important problems in Indonesian Customs in 2004:

- Of respondents who had interactions with Customs, 82% reported making informal payments, with 39% "occasionally" and 43% "frequently"
- Informal payments amounted to 2.3% of import value.
  Customs Clearance time (2005)
- It took 6 days on average to clear import shipments and 5 days to clear export shipments (2005)

This shows that the issues in Customs are serious and must be addressed. It is true that dwelling time can reduced by improving infrastructure through expanding ports, using more cranes and IT technology, but still Customs has an important role to play in reducing dwelling time.

Reducing dwelling time can also be achieved by improving coordination in the ports. Many institutions are involved in a port: customs, quarantines, the port authority and others. Improving infrastructure takes a long time and is expensive, but improving coordination is easier said than done, as many stakeholders are resistant to change, making reform extremely challenging. As such, feasible reforms that can be effective in the short-term are needed. If these reforms succeed, they can be used as success stories to inspire change in other institutions. One interesting case study is the efforts made to reduce dwelling time by Indonesian Customs. When Finance Minister Sri Mulyani introduced reforms in 2007 to improve Customs, significant improvements were made (Princeton, 2016). Still, dwelling time remained an issue. Figure 3 shows how dwelling time continued to rise before mid-2013. To handle this, in July 2013 the Ministry of Finance put special guidelines in place to gain quick wins in Tanjung Priok, Indonesia's biggest port. The reform was focused on Tanjung Priok because Tanjung Priok is accounted for more than 25% of total import volume in 2013.

Figure 3: Indonesia, Import Container Dwelling Time



Adopted from Sandee (2016)

This revamping was aimed at improving risk management. The number of goods requiring inspection (red lane) was reduced, while random checks were increased. This was a simple reform, and by reducing the amount of goods inspected through the red lane, the flow of goods improved. To minimize the risk of smuggling, random checks were increased by studying the profiles of importation companies.

The impact of this policy is illustrated in Figure 3, which shows that dwell time decreased significantly and continuously before rising again in November 2014. Of course it is premature to conclude that these improvements were due solely to the changes in risk management in Customs, as improvements to infrastructure and services in other related agencies in Tanjung Priok also contributed. Still, it can be seen that starting in July 2013 dwelling time was reduced. It must be noted, that while improving, dwell time in Indonesia is still far from satisfactory. Thus, as part of the structural reform, preparations for the National Single Window were also accelerated.

Criticisms and Shortcomings

While this approach to reform results in quick wins and provides political support for more complex reforms, there are a few weaknesses.

First, reform cannot only focus on quick wins. Reforms oriented to achieving long-term goals must be simultaneously be conducted, to replace the best-fit approach with a more robust best-practices approach. But problems can arise when best-fit reforms are inconsistent with best-practices efforts. As an example, the BKPM website using Costa Rican benchmarks was very effective in the short-term, but did not provide any room for creativity or staff development to make a truly customized and suitable BKPM website. Instant reform can cause problems in the long-term, as it does not effectively build institutions. The Indonesian Anti Corruption Committee (KPK) is the clearest example. The KPK is seen as a credible institution, able to deal with Indonesian corruption cases. But not many people are aware that the KPK was formed as an ad hoc institution, as there were doubts about the ability of other agencies (judges and the police force) to adequately fight corruption. The question is, will the KPK exist forever, or can these cases be returned to the Police and Courts? If the KPK remains, this means that we have not built effective institutions. This further reinforces the need for quick wins to be done simultaneously with institutional improvements to achieve best practices in the long-term. Without this, it will be very difficult to enact second-generation reforms.

Second, the case studies discussed above are just aimed at putting out fires. The reforms put in place to overcome the taper tantrum were reactive, meant to stave off the possibility of an economic crisis in 2013. Reducing the fuel subsidy, abolishing the beef import quota and eliminating the import tariff on soybeans were all temporary reactions. They don't mitigate future risk. This was proven in 2014, as the fuel prices could only be increased after a new government was in place and Joko Widodo's government eventually reapplied the fuel subsidies through Pertamina in 2017. Bank Indonesia allowed the exchange rate to follow the market in facing the taper tantrum at the same time as they tightened interest rates. But in the past several years, the government has openly showed its preference for Bank Indonesia to strengthen the rupiah's exchange rate and Bank Indonesia has decreased interest rates. These examples show that quick-win reforms run the risk of being short-lived and unsustainable. This is why it is vital that these quick win reforms are accompanied by long-term reforms, focusing on developing and building institutions, human capital, and a move toward best practices. It is difficult to ensure that short-term reforms are consistent with long-term reform goals. One way to do this is to make these reforms an automatic part of the institution. For example, the import quota was replaced by an automatic tariff system, in which if the international price deviated from domestic prices, the tariff would be applied automatically (raised or lowered to reflect the change in price). This could be done directly, without requiring cabinet debate or approval, except in special cases. The same is true for fuel. It is crucial that reforms be institutionalized, through regulations or laws. Efforts to guarantee fiscal sustainability, for example, asimbedded in the Financial Regulation of 2013, which determines that the budget deficit cannot exceed 3%, have helped the debt/GDP ratio to decline. Institutional reform is truly important.

Third, this endogenous reform and PDIA requires a long time, experimentation and a trial and error approach, which demand consistency and persistence, not always easily achieved in government.

V. Conclusion

Reform is not an easy process. Although economic theory provides guidance on the impact of reform on an economy and why it should be undertaken, it is silent on how it should be implemented. Furthermore, there is a lack of available research explaining how to conduct reforms in developing nations with less established institutions. In addition, reform must also be done within the existing politics and institutions. Undertaking reform by only referencing best practices without adjusting to existing political and institutional conditions, will only lead to failure. Conversely, if reforms can only be undertaken by changing the political and institutional set-up, we will have to wait too long for all of the institutions to be ready. Therefore, if institutions resemble "Jurassic Park", sophisticated "Star Wars" policies are not suitable. Thus, reforms should be customized to be the best fit for the existing situation. This can be accomplished by creating reform success stories and capitalizing on these to increase political and civil society support for more complex reforms, which is known as Endogenous Reform. Reforms can start with something very simple which is within our control, but which has a relatively large effect or marginal gain.

The three case studies above show how this approach was conducted in Indonesia. Still, it must be noted that this approach is not without its faults. It requires a long period of time, as well as consistency. In addition, reforms like these must be combined with long-term reforms to achieve best practice. The challenge is how to ensure "best fit" reforms are able to lead to "best practices" reforms. Indeed, there is no 'one size fits all' formula for reform. Thus, a flexible approach customized to political and institutional conditions is vital. In the end, reform is an art in policy implementation.

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