ECONOMIC FREEDOM IN INDONESIA:
REVIEW OF RECENT DEVELOPMENT

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Foreword

This report is the outcome of extensive research carried out by the Indonesian Institute, Center for Public Policy Research, comprising the revised outcome of the paper presented at the Public Discussion on 22 November 2007 at Menara Peninsula Hotel, Jakarta. It provides a comprehensive view of the Indonesian socio-political and economic condition.

Knowing what to measure and how to measure it makes a complex issue much less so. In order to examine the country's current situation, this particular report fittingly employs methods adhere to the recommendations forwarded by the Economic Freedom of the World (EFW) report, covering all five aspects of economic freedom measurement. Building on the pioneering work of the late Nobel laureate in economics Milton Friedman, the index published in the EFW report measures the degree to which the domestic institutions and policies support the foundation of economic freedom: personal choice, voluntary exchange, freedom to complete and protection of private property.

This study, in some way, stands at an avant-garde corner of research into the nature and pattern of the Indonesian socio-political and economic life. It makes a valuable contribution, however, not only towards an understanding of the Indonesian economy but also to the study of comprehensive political affairs amid societies beset by fundamental economic and social development.

We, the Economic Freedom Network Asia, are pleased to support the study. It is important to note that the financial support from the Friedrich Naumann Stiftung für die Freiheit, which has made possible the research programme, is gratefully acknowledged. However, the Foundation has no responsibility for the ideas set forth in this study.

As the coordinator of the Economic Freedom Network Asia, I am delighted that the study has now developed to the extent that it can be presented usefully as a report in both Bahasa and English. I am furthermore grateful for the effort of the many people who have contributed so much toward this report.

Dr. Gorawut NUMNAK
Coordinator of the Economic Freedom Network Asia

TABLE OF CONTENT

List of Tables & Charts

Economic Freedom in Indonesia: Review of Recent Development

"It is not from the benevolence of the butcher, the brewer, or the baker, that we expect our dinner, but from their regard to their own interest. We address ourselves, not to their humanity but to their self-love, and never talk to them our necessities but of their advantages."

- Adam Smith, The Wealth of Nations -

Introduction

I. Foreword

The collapse of the Soviet Union and downfall of the Berlin Wall were insufficient to stop the debate on the best-suited methods controlling economic activity. There are still continuous discussions regarding this matter, among academia as well as policy makers.

Nobel laureates such as Milton Friedman and Douglas North really believe that free a society – which later creates economic conditions that is free and market-based – is far more productive economically compared to other methods used to run economic activities. State involvement in influencing the market will only create disincentive to the economy.

The advocates of free market are certain that a free market system would produce competitions among economic agents. The competition will stimulate innovative ideas that would ultimately direct people toward a more prosperous life. Such comfortable environment would be reached since free market refers to incentives, productivity enhancement effort, and efficient use of resources that ultimately provide positive impact to consumers. The competition would even eliminate discriminations, since discrimination is costly. Competition will punish discriminative behavior.

The idea of economic freedom is based on ownership, personal choice, voluntary trade, and free entry to market. In other word, every individual has full freedom on everything they own as long as it does not conflict with the freedom of other individuals.

Therefore, if a country supports economic freedom, the government should guarantee the safety of individual private ownership and protect the certainty of law. If a country failed to protect private ownership, or develop barriers that restrict voluntary trade, thus the country can be assumed as hampering the individual freedom of its people.

On the other hand, advocates of free market face a strong challenge from its critics. Issues mostly criticized were that free market system only creates income disparity, environmental damage, extreme poverty, etc.

Advocates of market system certainly disagree with those arguments. However, without a measurement to economic freedom – in a form of index – the critics and advocates will only create endless debates.

Responding to the challenges, based on their belief, Milton Friedman, Douglass North and Mike Walker initiated the implementation of Economic Freedom of the World (EFW) project. This project was aimed to prepare an index of economic freedom in every country in order to prove that the market system had had a positive contribution toward people's economic development.

II. Empirical Evidence

The hard work from the project came into fruition. When the index was successfully created, there are so many scholarly work employ the index. The conclusion reached has always been similar, that economic freedom had positive impact on economic development, such as the study by Barro (1994), De Vanssay and Spindler (1994), Johnson and Sheehy (1995), Scully (1992), and DeHaan and Siermann (1998).[1]

Moreover, economic freedom also reduces poverty level, hold infant mortality rate, support democracy, and expand life expectancy of communities.[2] In addition, Tures (2003) stated that economic freedom is able to reduce the potential of social conflict.

III. Rank of Indonesia

Indonesia's rank always changed from time to time. This can be caused by the changes in the number of countries rated or the indication whether Indonesia's economic freedom climate is getting better or worse. Below is Indonesia's rank based on the number of countries measured:

Table 1. Indonesia's rank in the economic freedom climate

1970	1975	1980	1985	1990	1995	2000	2001	2002	2003	2004	2005
43 out of 54	47 out of 72	64 out of 105	28 out of 111	31 out of 113	45 out of 123	79 out of 123	99 out of 123	89 out of 123	77 out of 127	82 out of 130	86 out of 141

Source: The Economic Freedom of the World Project. 2007. Retrieved from http://www.freetheworld.com/ on 23 October 2007.

1 Madan, Anisha, 2002, "The Relationship between Economic Freedom and Socio – Economic Development", http://www.econ.ilstu.edu/uauje

2 For a more complete version, see Gwartney, James and Lawson,"Ten Consequences of Economic Freedom" NCPA Policy Report No. 268

RESEARCH BACKGROUND

I. Problem Identification

Based on the above ranking, according to EFW, since 1970 Indonesia has always been categorized as a country with a "unfree" economy. Theoretically, this would hinder its potential growth. In fact, currently Indonesia need higher growth rate to decrease its unemployment and poverty level.

II. Research Question

The research question raised was: within this last couple of years, has the government of Indonesia given their share of contribution in providing proper climate of economic freedom in Indonesia?

III. Research Objective

Based on the research question above, hence this research was aimed to provide evaluation on the current economic condition and its impact toward economic freedom in Indonesia.

METHODOLOGY

In conducting evaluation on economic freedom in Indonesia, we used a framework has always been used by Gwartney and Lawson (2007). But, we believe that several variables should be adjusted to fit Indonesia's context.

Our research object is the Republic of Indonesia, whereas, the data used mostly describe the condition in 2004, 2005, and 2006. Most of the data was gathered from various sources, such as from the Central Bureau of Statistics (BPS), Bank of Indonesia (BI), the World Bank (WB), and the Department of Labor and Transmigration (Depnakertrans).

It is expected that by providing data and describing the background, we could obtain a description on the development of economic freedom climate in Indonesia. Five aspects were evaluated, i.e.:

I. The Role of Government in National Economy

The evaluation objective from this aspect was to obtain a description on how big or small the government's role in national economic activity. In economic decision-making process, very often the government is held hostage to its political interests. This was different compared to individual decisions, which was dominated solely by economic interest. Therefore, the bigger the role of the government, the smaller the role of individuals is involved in economic activity. In order to obtain that description, we calculated the ratios between:

1. **Consumption to Gross Domestic Product (GDP) Ratio**
   The calculation shows the domination of the government consumption expenditure toward the economy. When government consumption increased, that means individual, household and business sector spending is replaced by decisions by the government, which tend to have political aspect. Therefore, it decreases individual economic freedom.

2. **Subsidy to GDP Ratio**
   The calculation shows the role of subsidi in the economy. Principally, subsidy limits people's economic freedom in obtaining their desires. If people have no intention on subsidized products, they automatically will not enjoy a subsidy. Therefore, those people face limited choices.

   In addition, subsidy is obtained trough tax collected from individuals to be transferred to other individuals. The larger the subsidy reflects the growing dependence of a group of individual to another.

3. **State Owned Enterprises (BUMN) to GDP Ratio**
   This ratio shows the role of government toward GDP through state enterprises. In other word, this ratio shows how big the dependency of national economy toward state enterprises. The bigger the role of BUMN to national economy, the smaller the role of the private sector. It will automatically lessen the freedom of individual.

4. **Income tax to GDP Ratio**
   This ratio shows the dependency of individuals toward the government. The high rate of income tax will decrease the individual freedom of workers to enjoy the fruits of their labor.

II. Legal and Governance Aspect

A guarantee that the government will protect individual ownership rights is key element to economic freedom. Furthermore, the success of the state in providing guarantee depends on law enforcement in that country. On the other hand, law often times is intervened by political force.

Therefore, the aspect of law enforcement and various factors that has influence on it needs to be evaluated. This is done in order to find out how big the state can guarantee individual ownership – that is economic freedom – and its legal assurance.

To obtain a better description, we used the following indicators: [3]

1. *Voice and Accountability (VA)* – measuring the extent to which a country's citizens are able to participate in selecting their government, as well as freedom of expression, freedom of association, and a free media.

3 Kaufmann, Daniel, Kraay, Mastruzzi (2007),"Governance Matters VI: Aggregate and Individual Governance Indicators 1996-2006", The World Bank.

2. *Political Stability and Absence of Violence (PV)* – measuring perceptions of the likelihood that the government will be destabilized or overthrown by unconstitutional or violent means, including domestic violence and terrorism
3. *Government Effectiveness (GE)* – measuring the quality of public services, the quality of the civil service and the degree of its independence from political pressures, the quality of policy formulation and implementation, and the credibility of the government's commitment to such policies
4. *Regulatory Quality (RQ)* – measuring the ability of the government to formulate and implement sound policies and regulations that permit and promote private sector development
5. *Rule of Law (RL)* – measuring the extent to which agents have confidence in and abide by the rules of society, and in particular the quality of contract enforcement, the police, and the courts, as well as the likelihood of crime and violence
6. *Control of Corruption (CC)* – measuring the extent to which public power is exercised for private gain, including both petty and grand forms of corruption, as well as "capture" of the state by elites and private interests
7. Ownership registration – measuring the ease in registering ownership of an asset. The measurement is based on the length of time and the costs needed.
8. *Enforcing Contracts* - measuring the procedure, cost and length of time needed to enforce contracts.
9. Ease of closing a business - the length of time and cost needed to close a business, also the recovery rate obtained.

III. Access to Sound Money

Trade gives gains to both seller and buyer. High inflation rate however in turn will decrease the real value of trade, especially if the inflation rate tends to be highly volatile. This will cause difficulty for businesses to predict future inflation rate.

Lower gains and the difficulty to predict inflation rate will lessen the freedom to trade because of the disincentive created. Therefore, the objective to measure this aspect is to find out the currency stability rate in an economy and what is the inflation volatility rate in that country. Indicators used are as follow:

1. The gap between the growth of money supply with real GDP and inflation.
   This indicator shows the difference between money supply with economic growth and inflation. Ideally, the average growth rate of money supply (M1) is equal to the sum of average real GDP growth and average inflation in the long run.

2. Inflation rate from several years back.
   This indicator shows the inflation rate for the last three years. Economic freedom will rise if inflation decreases from year to year.

3. The volatility of inflation rate for the last five years.
   This indicator shows the difficulty rate in predicting inflation rate. The bigger the number, it will be more difficult for businesses to predict inflation rate. Therefore, it will hamper their freedom to make business decisions.

IV. International Trade

In practice, currently almost every country in the world has become an "open economy". The difference lies on the degree of openness. With specific purpose, many countries create barriers of goods, in the form of tariffs and non-tariffs, such as to increase tax revenue, or various forms to protect toward domestic market.

Export-import tax is one type of barrier in the form of tariff. On the other hand, one form of non-tariff barrier is the ease of document handling; scaled by how many documents needed, the time, and cost needed to engage in international trade.

Furthermore, barriers on international trade not only restrict economic freedom, but also create other problem that can have dire consequences, like smuggling. In such a case, honest importers who pay duties will lose competitiveness due to a more expensive product sales tag.

Then, this aspect not only measures the barrier in engaging trade activity, but also barriers in foreign investment activity. For foreign investment, we divided into two type, foreign direct investment and portfolio investment.

Currency black market is an indicator of exchange rate flexibility. If a country uses floating exchange rate regime, therefore there is a slim chance that foreign currency black market will appear. But, if the country uses fixed rate of exchange, there is a chance that black market foreign currencies will appear, because there is a difference between nominal and real exchange rate.

Briefly, indicators that we used to evaluate these aspects are as follow:

1. Export-import tax
2. Ease in processing documents
3. Controlling foreign capital flow
4. Foreign currency black market

V. Credit, Labor and Business Regulations

These aspects are evaluated to find out how far the government plays a role in arranging activities in the loan, labor and business market. Indicator we used was as follow:

1. **Asset acquisition, credit offering and third party funds by State Owned Banks.**
   This indicator shows the role of state owned banks in stimulating the economy. We measure the contribution of third party funds toward the total third party fund that can be collected by the banking sector. Because, the more funds that are collected, the bigger the funds that can be channeled to stimulate the economy. The bigger the role of state owned banks, the smaller the role of private banks is supporting economic activities.

2. **National minimum wage.**
   This indicator shows the growth rate of national minimum wage set by the government. The policy itself actually reduces economic freedom, of those seeking for employment and those who open up jobs.

3. **Flexibility in the labor market.**
   This indicator shows the condition of labor market flexibilities. Similar to minimum wage policy, this indicator shows the degree of economic freedom, those who seek jobs and those who provide jobs. The more inflexible the labor market, the lower the economic freedom. To gain a better description, indicators that we observed is as follow:
   a. Difficulty in hiring workers
   b. Rigidity of working hour
   c. Difficulty to dismiss workers
   d. Cost of dismissing workers

4. **Business regulation.**
   This indicator shows the degree of ease in doing business and its supporting activities. The more the regulation, the more difficult and expensive it will be to start and terminate a business. The more the regulation will create barrier to enter the market. It automatically reduces the economic freedom of people engaging in business. To gain a better picture on the difficulty degree of business regulation, we used the following indicators:
   a. Starting a business
   b. Time needed obtain permit
   c. Flexibility of the labor market
   d. Property registration
   e. Obtain credit/loan
   f. Investor protection
   g. Paying tax
   h. International trade
   i. Contract Obedience
   j. Business closure

Economic Freedom in Indonesia

I. Role Of Government: Spending, Tax, Dan State Owned Enterprise

The increase of oil prices in the world market forced the government to decrease the subsidy of fuel. As a result, gasoline prices increased. Unfortunately, soon after, world oil prices fluctuated again in a more severe intensity.

As a result, the government, again decrease subsidy. Fuel prices further increase at the beginning of the last quarter in 2004, with an average of more than 100 percent (table below).

Table 2. Movement of fuel prices

Date	Pertamax Plus	Pertamax	Premium	Kerosene	M. Solar	M. Diesel	Burning Fuel	Note
1 October 2004	2.75	2.45	1.81	1.8	1.65	1.65	1.56	Retail Price
			2.1	2.2	2.1	2.05	1.6	Industry Price
1 March 2005	4.2	4	2.4	2.2	2.1	2.3	2.3	Retail Price
			2.87	2.79	2.7	2.66	2.3	Industry Price
1 October 2005	**5.9**	**5.7**	**4.5**	**2**	**4.3**	**-**	**-**	
			5.16	**5.6**	**5.35**	**5.13**	**3.15**	Market Price

Source:Pertamina

As compensation, the government promised to provide cash subsidy (BTL) to poor families. While for the business community, the government had promised to provide tax incentive to several sector of business.

The weakening performance of business as a result of the increase in fuel prices made the government play the role as "engine of growth". The way to do it was by encouraging fiscal stimulus through the implementation of various projects. It is hoped that this will balance the low performance of the business sector while creating the infrastructure needed to smoothen economic activities.

But, the government experienced constraints in carrying out the role. The implementation of projects ran very slowly due to the indiscipline in budget liquidity.[4] In the first semester of 2005, only 6 – 7 percent state budget was spent from the total budget that year. This is because there was a change on the budgeting system – through the enactment of State Finance Law – and the long budget discussion at the People's Representative Assembly (DPR). Thus, the liquidity of the 2005 budget was delayed.

4 The delay of Government budget realization has happened for several years in a row. Description of 2005 is only for illustration purpose.

As a consequence, although government tried to accelerate the realization of its spending, at the end of 2005, its spending level was only reached 90 percent. The remaining Rp 12.95 trillion was carried over to the 2006 budget.[5]

The failure to use the budget was caused by several aspects, such as:

a. Government departments or agencies were unprepared in using the allocated funds due to the lateness in appointing its technical officials.
b. Public goods projects like infrastructure development were constrained by land lease.
c. The eradication of corruption caused the unwillingness of officials to become project managers. They worry to be accused of corruption if the project does not run according to plan.
d. The difficulty to uniform the central and local government's program policies. Development program at the local level is intended to support programs at the central level. In other word, the synergy between national and local targets did not occur.

The impact from the slow use of budget will create crash programs, that is more difficult and tend to disregard the quality of work.

Here we can see how the government did not do their job to spread income. Taxes collected from the people should be reentered to the economy through the development of infrastructures to increase economic activities.

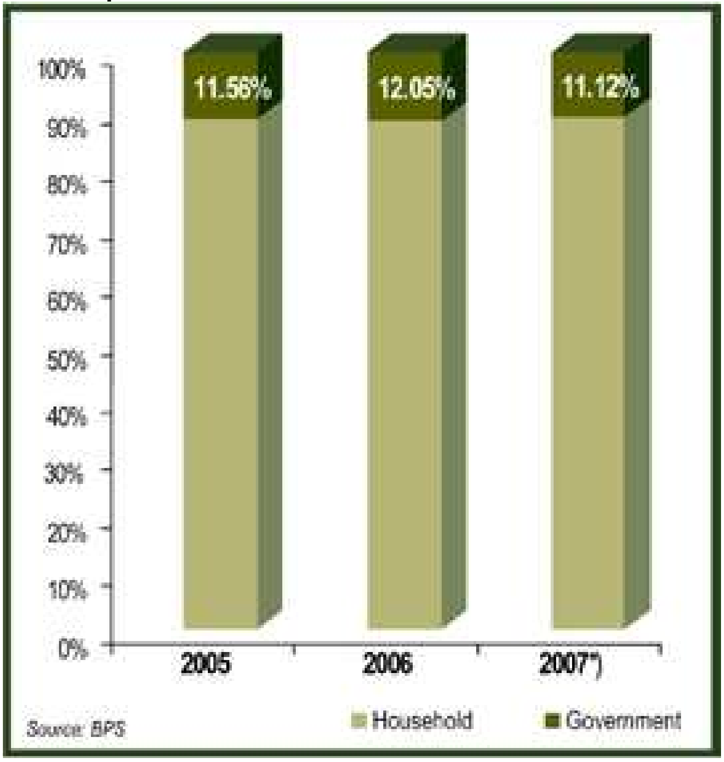
But what happen was the unused of funds that did not benefit anyone. Therefore, tax decrease is appropriate to consider.

1. Consumption

As seen in the chart below, in the year 2005 through the projection of 2007, the government consumption to the total national consumption ratio change very little. But, the government consumption in 2006 ran faster, which was eight percent. On the other hand, household consumption only grew three percent.

5 To ensure the government program's effectiveness, the government and DPR agreed to delay the realization until April 2006. However, Ministry of Finance however report that budget realization is still at its minimum level until the beginning of April, meanwhile the budget should be completely realized in 2005. Worse, the idle allocated budget was invested in Bank Indonesia Notes (SBI).

Chart 1. Consumption to GDP Ratio



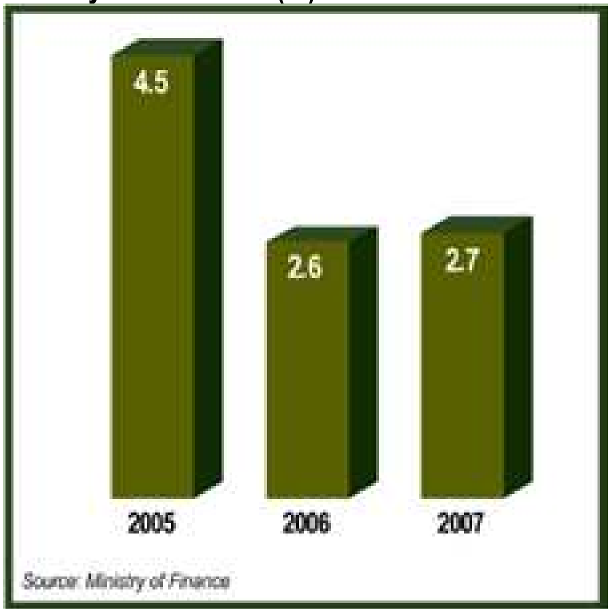
This might be caused by pressures to make the government to act as machinery for economic growth. The pressure appeared because throughout 2005 the government increased fuel prices twice, which had created the weakening expectation of people's spending power. To balance it out, the government deemed necessary to increase its consumption.

But, entering the next year, in 2007, the government's consumption level decreased again, in fact below the 2006 level. The decrease of government consumption will cause the increase in individual choices in the consumption of goods and services.

2. Subsidy

The chart below shows the subsidy to GDP ratio. In 2006, the ratio decreased to only 2.6 percent, from the previous of 4.5 percent, and then it increased again the following year.

Chart 2. Subsidy to GDP Ratio (%)



The high rise of subsidy happened in 2005, which was caused by the rise of fuel subsidy. 3.4 percent GDP is fuel subsidy. Non-fuel subsidy is the remaining of 1.1 percent.

The high rise of fuel subsidy was caused by the high world oil prices, which created the perception of fiscal at risk to the Government of Indonesia as fuel importer. This has caused investors to panic.

Entering the year 2005, the exchange rate of the Rupiah towards the Dollar deeply plunged. As a result, the government increased fuel price at the end of 2005. As a consequence, fiscal pressure decreased because the subsidy became smaller, as shown on the chart above.

But, since last October 2007, world oil prices increased again with high acceleration. Many predicted that the increase would reach 100 dollars per barrel. If this happens and lasted for more than three months, therefore the average fuel price would increase.

As a consequence, the disparity between domestic and international fuel price will become larger. In order to decrease fiscal pressure, logically the government must once again increase local fuel prices.

But, we predicted that it has a small possibility because the economic condition is unprepared to experience another increase in fuel prices. Moreover, the President of Indonesia already promised not to further increase fuel prices.

Therefore, if oil price became an average of 80 dollars per barrel, this will make a gap of 20 dollars per barrel from the assumed Budget change of 2007. As a result, fuel subsidy will experience an increase of Rp 15 Trillion.

This condition is different from 2006, where oil prices did not experience a steep rise. On the other hand, as a result of more than 100 percent increase in fuel price at the last semester of 2005, domestic fuel consumption at one time decreased 40 percent. This has a positive impact on fiscal sustainability.

We can conclude that, the subsidy to GDP ratio of 2007 has high possibility to be not lower than the 2006 ratio. This would bring the degree of economic freedom unchanged compared to the previous year.

3. State-owned Enterprise (BUMN)

The chart below shows a decrease in BUMN to GDP ratio. Theoretically, the decrease in assets can interpreted as a decrease in the ability to produce.

In line with the principle of economic freedom, this produces a positive impact. This is the case because the decrease of BUMN assets will provide a bigger working space for the private sector in contributing to national economy.

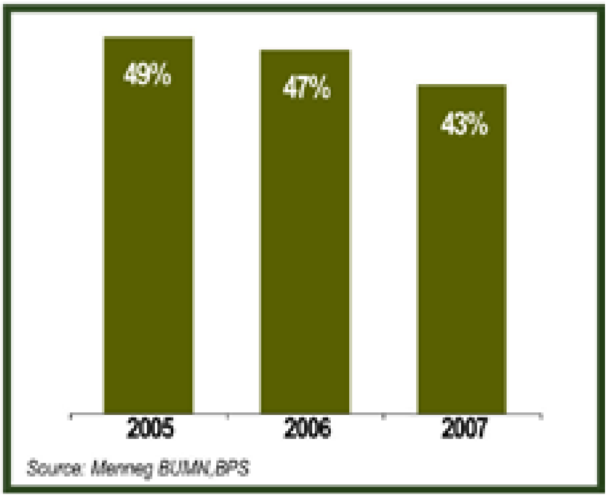
But, we believe that the positive impact is not sustainable. In other words, the decrease in assets was caused by macro-micro economic factors, because by ideology the Government of Indonesia wanted BUMN to play a significant role in national economy.

This can be seen by the government's intention to develop BUMN, by revitalizing them.[6] The strategy taken by the government is by decreasing the number of BUMN. If in 2007 the total number of BUMN is 102 companies, by the year 2009 it is hoped that only 69 companies remain. Because the decrease in number will be done by business consolidation – with merger and acquisition – therefore, *ceteris paribus*, it is logical to assume that the value of BUMN assets will increase in the years to come. This create disincentive to the position of private sector in the market.

Therefore, what is shown on the graphic has the potential to create misleading conclusions. In other words, the decrease in BUMN assets will not be a trend. The number of BUMN decreased, but the assets will be bigger. If this happens, it will have negative impact on economic freedom.

6 Noble goal of this revitalization is to eliminate image of BUMN. For years, BUMN has been considered as inefficient business organization, even frequently judged as "cash cow" of politicians.

Chart 3. BUMN Assets to GDP Ratio



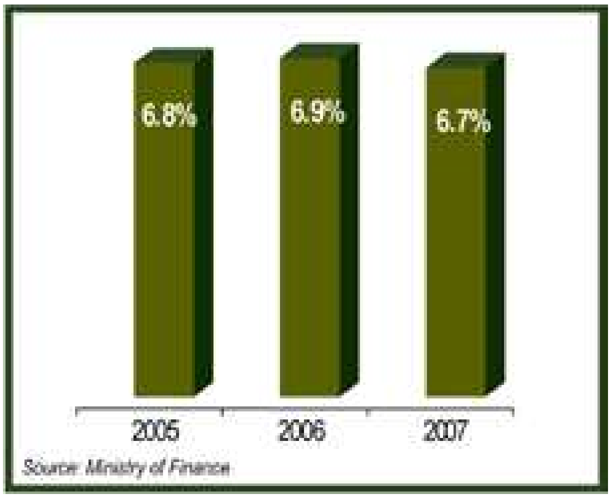
But, the thing to consider is the government's spirit to privatize BUMN. Several BUMN that are profitable is offered to the private sector or even people in general through stock exchange.

Additionally, another positive thing is that almost all of BUMN ini Indonesia face competition in marketplace. In other world, most of them do not operate in protected market. This is a positive development, although the government still holds the majority of shares.

4. **Income Tax**

The chart below shows that there is not any noticeable difference in the 2007 income tax ratio compared to the previous years. This is because the growth of national output and people's income. However, growth acceleration of the tax value increased, from 17 percent in 2006 to 19 percent in 2007.

Chart 4. Income Tax to GDP Ratio



But, note that over the years, income tax contributed to almost 50 percent of total budget received by the government. That reflects the high dependency of the government towards income tax revenue.

In principal of economic freedom, this decreases people's freedom to consume the earning gained by working hard. On the other hand, the high tax reflects the government's role in the arrangement of the operation of national economics.

As long as the income tax ratio does not change, people's economic freedom will not improve.

II. Legal and Governance

Legally, Indonesia can be categorized as using "civil law" system, adopted from colonial Dutch legal system. Whereas, for Anglo-Saxon countries like Great Britain and its commonwealth, United States, Australia, Canada and New Zealand uses "common law" system.

La Porta, et al (1998) found that civil law gave weaker legal protection to investor and creditors interest compared to common law, which gave stronger protection to share holders and creditors. It is no wonder that the financial sector of countries using common law system tend to develop better.

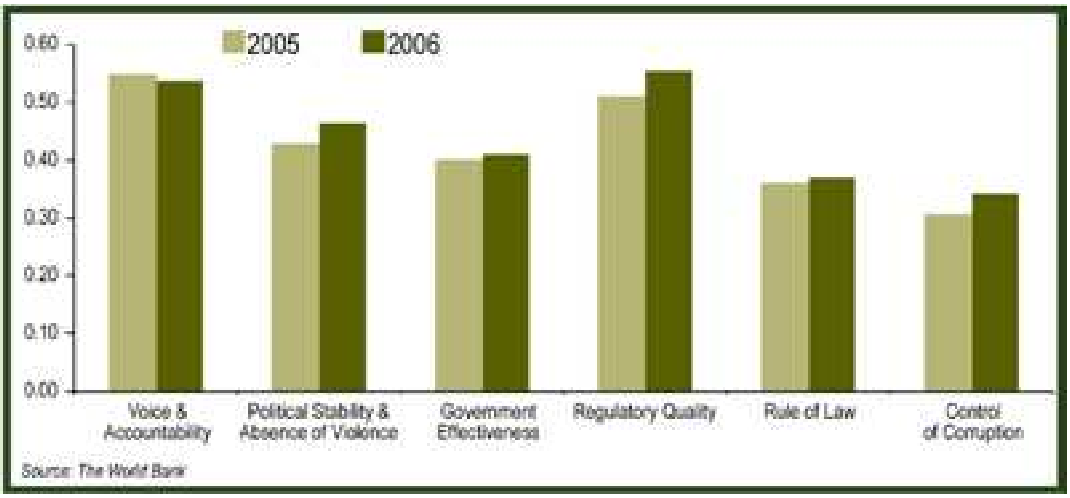
Legal system that does not lean toward the business community and the high uncertainty of the legal system caused Indonesia to lose its attractiveness as a place for business. Moreover, legal violations were even frequently done by the legal authorities themselves.

Report by local transportation organization (Organda) stated that various illegal taxation on the streets throughout Indonesia the value in a year reached Rp 18 trillion. Ironically, most of the illegal taxation was done by law enforcers; the police, road transportation local officials and government officials, towards drivers that pass the road.[7]

The chart below shows an index improvement on almost every aspect. This is a positive development. Political stability, rule of law, and the increased control of corruption are conducive to economic development in Indonesia. But, it should always be improved, especially on the issue of powerful court mafia.

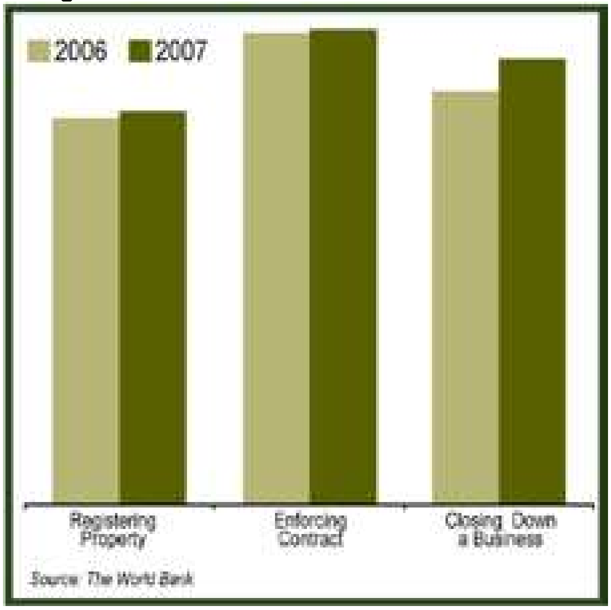
7 Suara Pembaruan Daily August 23, 2006,"Pungli Jalanan Mencapai Rp 18 Triliun per Tahun"

Chart 5. Indicators of Gofernance



Also, business has become easier, as shown in the chart below.

Chart 6. Doing Business in Indonesia: Some Feasibilities



Contract fulfillment, which is always a problem, is currently starting to show sign of improvement.

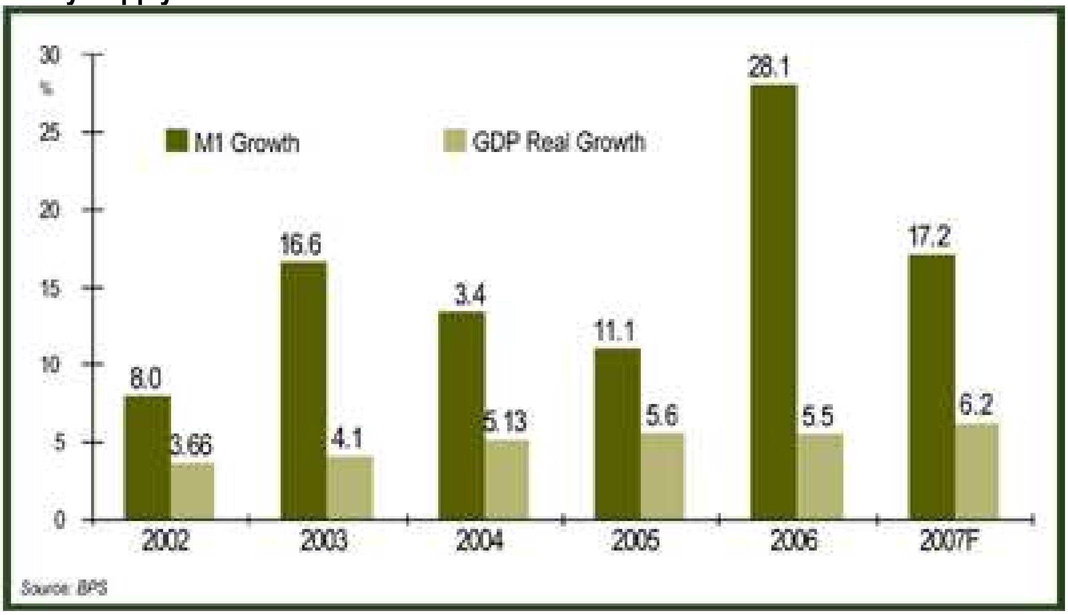
III. Access to Sound of Money

1. Money Supply Growth

The chart below shows that the narrow money supply growth (M1) turns out not running with the real GDP growth. Moreover, from 2003 to 2006 the correlation between money supply growth and economic growth is seen theoretically inconsistent.

But, it does not mean that there is an anomaly. The total money supply growth (M2) is still a relevant factor towards economic growth. This has high possibility caused by the high increase in economic activity that is financed by quasi money (non cash transaction).[8]

Chart 7. Money Supply Growth



The chart above shows that the growth margin between M1 and Real GDP is starting to show an encouraging development relative to the years before that. Unfortunately, in 2006, the margin increased dramatically. If calculated, the number can reach 22.6 percent.[9]

Even though that is the case, if we look at it in the long run, the growth disparity between M1 and GDP actually still run in a reasonable amount. We believe that the margin between the average growth of M1 and the sum of average GDP growth with inflation is only 1.5 percent.

8 According to BI, Indonesian society is gradually move to non cash transaction. This has been reflected from the growth of credit card and debit card usage, which achieved the level of 15-30 percent per annum, and 25-30 percent per annum. Additionally, money supply statistics showed that ratio between the usage of cash and non cash transaction was 48:52 percent. Predictably, the ratio will grow.

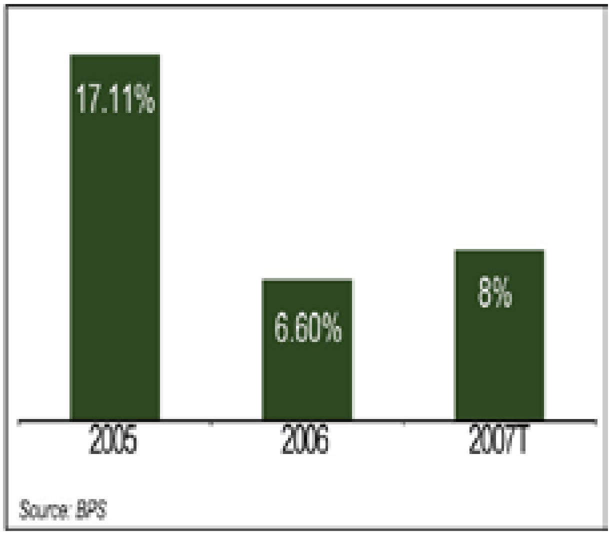
9 As shown above, the gap was resulted by hiking number of money supply. This has been caused by improving condition of haousehold consumption in the last quarter in 2006 for improving purchasing power and relaxing inflation. Improving consumption indicated by increasing of consumption of non-food goods, motorcycles sales, electronic products, cars, and other durable goods.

2. Inflation Rate

As stated beforehand, that in 2005 there was an increase in fuel price twice. The last increase in price was at the beginning of the fourth quarter, where fuel price rise as high as 100 percent. This resulted sky-rocketing inflation rate.

But inflation pressure diminished the next year with only 6.6 percent. For 2007, the government set the target inflation of around 8 percent

Chart 8. Annual Inflation Rate



Apart from whether or not the government will reach the target, the steep increase and decrease of inflation rate had caused volatility. Our calculation showed that the standard deviation of inflation rate for the period of 2002 to 2006 reached 4.85. This number was slightly higher than the period of 2002 to 2005 that reached 4.83.

If the government reaches its target, the volatility of inflation for the period of 2003 to 2007 will decrease again to 4.83 percent. Therefore, it brings positive impact to the economic freedom climate because low volatility eases economic agents in making business decisions.

IV. International Trade

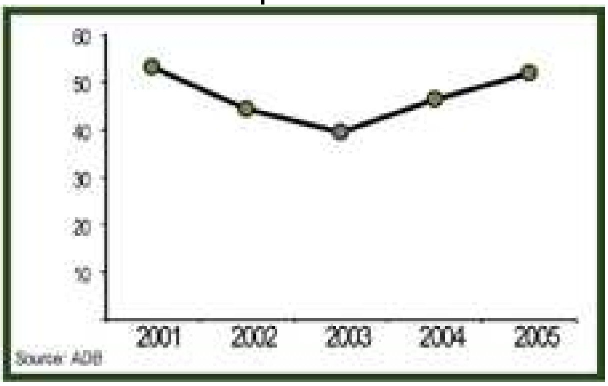
The era of free trade forced Indonesia to increase its product competitiveness in international market. One effort done by the government was by signing cooperative agreements with other counties.

The following is a series of cooperative agreements formed, individually or collectively as a member of ASEAN:[10]

1. ASEAN Free Trade Area
2. ASEAN-Australia and New Zealand Free Trade Agreement
3. ASEAN-China Free Trade Area
4. ASEAN-EU Free Trade Agreement
5. ASEAN-India Regional Trade and Investment Area.
6. ASEAN-Japan Comprehensive Economic Partnership
7. ASEAN-Korea Free Trade Area
8. East Asia Free Trade Area
9. India-Indonesia Comprehensive Economic Cooperation Agreement
10. Indonesia-European Free Trade Association Free Trade Agreement
11. Japan-Indonesia Economic Partnership Agreement
12. Pakistan-Indonesia Free Trade Agreement
13. Preferential Tariff Agreement-Group of Eight Developing Countries
14. US-Indonesia Free Trade Agreement

Various cooperative agreements gave contribution toward international trade. As shown in the chart below, according to the Asian Development Bank (ADB), Indonesia's trade openness has improved since 2003.

Chart 9. International Trade Openness



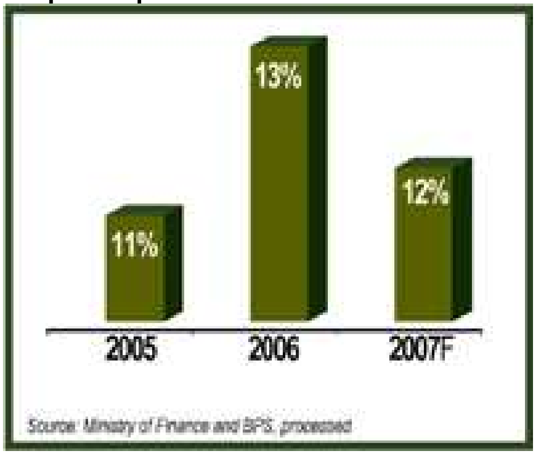
Even though the trade openness index showed positive development, Indonesia's exporters and importers still face various constraints in running its business activity. The constraints, among others are: weak infrastructure, many unauthorized taxes, and inefficiency in the ports.

If the government is able to solve those constraints, national trade activity is sure to improve.

10 Asian Development Bank (2007)

1. **Export-Import Tax**
   As shown in the chart below, the tax received by the government from international trade activities increased. This reflects the increase in barrier toward international trade activities.

Chart 10. Export Import Tax



To make things worse, if we observe more closely, it turns out that the increase in the government's revenue export-import activities is larger than the export-import growth itself. International trade growth was 17.9 percent, but tax growth is 37.4 percent.

Without any policy to cut tax, trade activities will not show the performance that reflects its potential. This symptom started showing in 2007. Since the beginning of the year, the government had revised its export target, from 20 percent to only 14.5 percent for the year 2007.

Therefore, to fix economic freedom, tax cut is needed. Moreover, the decrease in international trade performance was not only caused by domestic factors. The decrease in performance of major economic business partners like the US and the increase in technical policies stated by destination countries, caused tighter product competition in the world market.

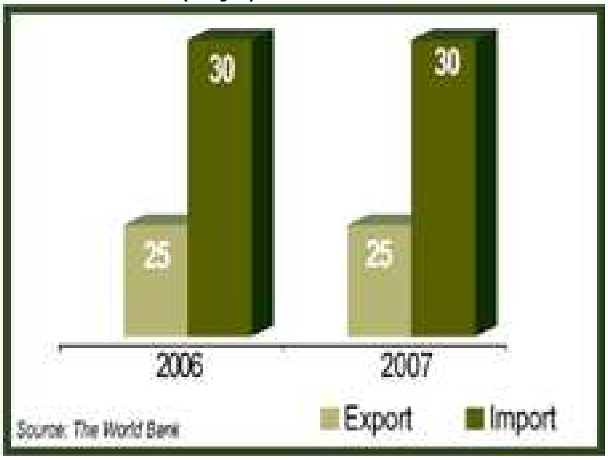
Apart from that, tax and tariff also caused other problems. Especially import activities. The Department of Finance reported that 6,200 importers, or more than 40% from a list of 14,515, have high risk of engaging in smuggling activity. This is detriment for legal importers that already paid import duties, so they had to increase their selling price. In other words, taxes imposed would create unhealthy competition in domestic market.[11]

11 Smuggling itself would not be easy to alleviate. According to the Ministry of Finance, there are several reasons caused, such as unbalances between salary and renumeration package to risk burdened to the officials, and there is weakness in customs system.

2. **Document Processing**

Tax is not the only factor of barrier in international trade activities. The following chart shows time needed to process documents to support trade activities.

Chart 11. Time Needed (days)



As shown above, there is no major improvement in 2007 compared to the previous year. This reflects the ineffectiveness of reform by the government to speed up the processing of international trade documents.

In fact, the time needed to process these documents can be associated to the high cost needed to finish a business contract. The impact is that the competitiveness of Indonesian products is not improving.

On the other hand, it has a unique challenge to implement bureaucracy reform. Resistance will of course emerge from the parties who benefited from the long chain of bureaucracy in processing those documents.

Observing that there is not any strict action taken by the government, we can predict that there will not be any significant changes in the following year.

3. **Currency Black Market**

Not long after the monetary crisis struck, Indonesia changed its currency regime from guided floating rate to floating rate. The advantage of floating rate system is the low incentive for black market to make foreign currency transaction. This is because the currency is already in market price; therefore it is impossible to earn a higher premium.[12]

12 Nevertheless, black market for foreign exchange exists albeit its small number. The actor is individual and gathered in an area of Central Jakarta. The spread between official and unofficial foreign exchange they offer only 50-100 point.

4. Controlling Foreign Capital Flow

For almost 40 years, investment activities – whether foreign or domestic – was regulated by Law No. 1 1967 on Foreign Investment (PMA) and Law No. 6 1968 on Domestic Investment (PMDN). In 29 March 2007 the People's Representative Assembly (DPR) enacted the new law on investment.

The birth of the new law is an important history for investment climate in Indonesia. The last laws were irrelevant and did not accommodate the improvement of competitiveness to foreign investors. This is indicated by the low of foreign investment that had entered Indonesia. From 1998 to 2004, the average foreign investment approval plummeted that reached negative growth of -0.45 percent.

The birth of the now law then followed by the publication of Investment Negative List (DNI) on 3 July 2007, that is stated in Presidential Regulation (Perpres) Number 77 Year 2007 and Number 77 Year 2007. This Presidential Regulation regulates the business sectors that are open and closed with requirements for foreign investment. Therefore, Presidential Decree (Kepres) Number 118 Year 2000 and Kepres Number 96 Year 2002 no longer apply.

In addition, on July 3,2007 government has released Perpres Number 76 year 2007 and Number 77 year 2007, comprised of negative investment list (DNI).

The criteria on listing businesses that is closed in DNI only based on health, safety, defense and security, environment, moral and culture and other national interest aspects.

As for businesses that are open with requirements is arranged with the consideration of protection toward small and medium businesses (UKM), production and distribution monitoring, and increasing technological capacity.

The new DNI regulates around 300 business sectors and the limitations do not apply to businesses that already existed. The increasing number of business sector regulated does not mean the increase of barriers to the business sectors. It only means that the more business sector regulated reflects the more detail the new DNI.

Making the DNI more detailed has positive impact. The more detailed the business sector is regulated, the less the"gray area" that might arise. The impact is that misinterpretation will be minimum and more transparent to investors.

But, there are things that the government must do, like providing additional explanations to the Perpres. This is because there are possible critical questions around the DNI.

For example, why does the movie business is included in the DNI? In fact, foreign ownership in the industry can improve national filmmaking. Also for the foreign ownership in fixed line telecommunication sector, maximum ownership is only 49 percent.

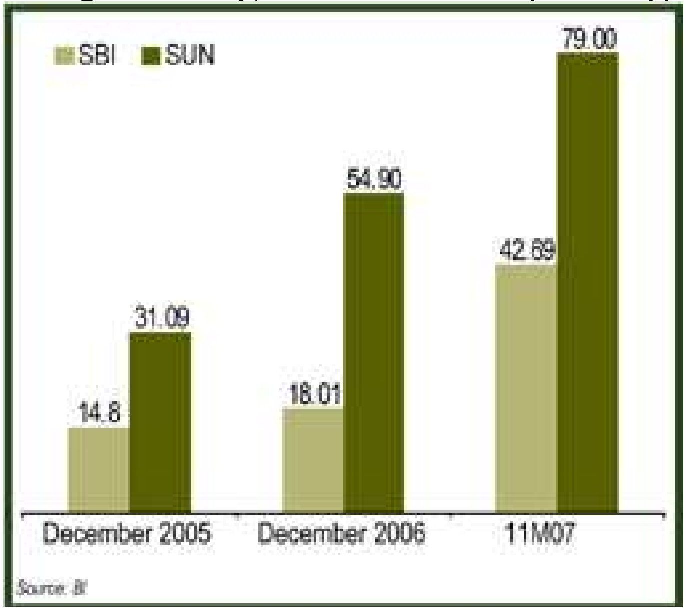
As one of the sector that has an important role in infrastructure improvements, the telecommunication industry still need performance improvement though increased capacity of community service and better development research. To realize that goal, foreign players are needed to make the market more competitive.

The conclusion is that the publication of DNI of course restricted economic freedom, especially if the general public does not know the basis of decision-making.

But, the opposite happens in foreign ownership through various financial asset instruments. Several times the Bank of Indonesia (BI) tried to convince that there is no limitation to foreign ownership. Also the government does not make limitation on buying Government Bond (SUN).[13] No limitation for foreign investors in financial instrument has positive impact toward economic freedom.

The chart below shows foreign ownership in Bank of Indonesia Certificate (SBI) and Government Bond (SUN).

Chart 12. Foreign Ownership, Portfolio Investment (Trillion Rp)



The high interest of foreign investors to invest their capital in financial assets is not a phenomenon that only happens in Indonesia. This is also felt by other developing counties. There are several things that made this possible, among others are:

1). High global liquidity caused by the low global interest rate for the period of 1998 to 2004.

13 The government effort to limit foreign ownership has been only applied in retail government bond market.

2) The improvement of economic condition of developing countries, and encourage its people to be investment community.

3) The non-existence of tight control and regulation from stock market authorities in the activities made by foreign investors in developing countries like Indonesia.

4) The in-flow of foreign capital from capital abundant nations to the capital scarce countries theoretically will lower interest rates, which has positive impact on businesses.

V. Credit, Labor and Business Regulation

According to the survey by World Economic Forum, in 2006 Indonesia will improve its rank in global competitiveness. In 2005 Indonesia was ranked 69 from 107 countries, whereas, in 2006 Indonesia reached 50 from 125 countries.

Several adjustments made by the government came into fruition.

But, there are still to be done by the government – in this case the central government – regarding regional autonomy. Prof. Dr. Ryaas Rasyid stated that in 2006 there were 20,000 ”troubled” local regulation (Perda). While in 2003, the troubled local regulation was only 7,000 cases.

The long list of taxes imposed by local government is proof that there is no aspiration towards investment initiatives. The local government expected to create breakthroughs to ease investment in reality gave more burden to businesses in their regions.

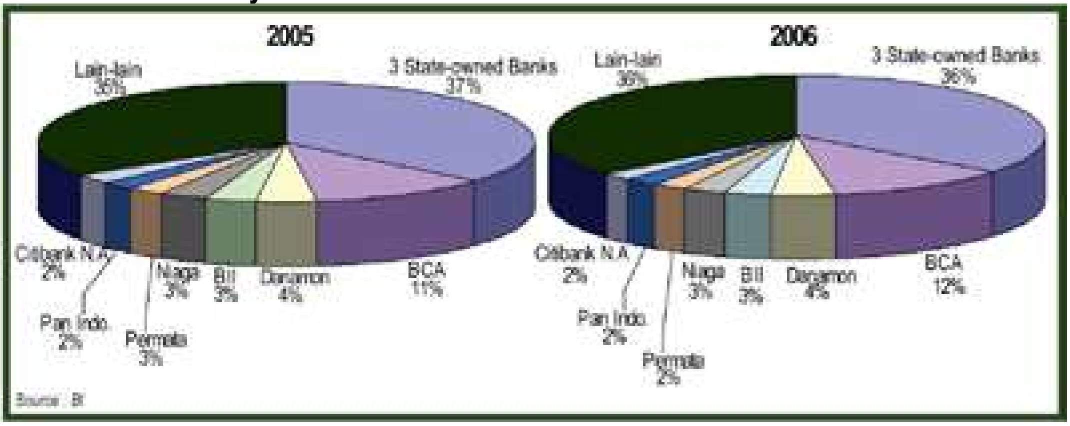
1. Credit Market

Indonesia is a bank-based economy. That means among the financial institutions, banking plays the most important role.

The chart below shows the share of third-party funds (DPK) by general banks in Indonesia. A shown in the chart, three State Owned Banks; Bank Mandiri, Bank Negara Indonesia (BNI), and Bank Rakyat Indonesia (BRI) holds 37 percent of the total third-party funds from the total third-party funds collected by the banking sector. This happened in 2005 and 2006.

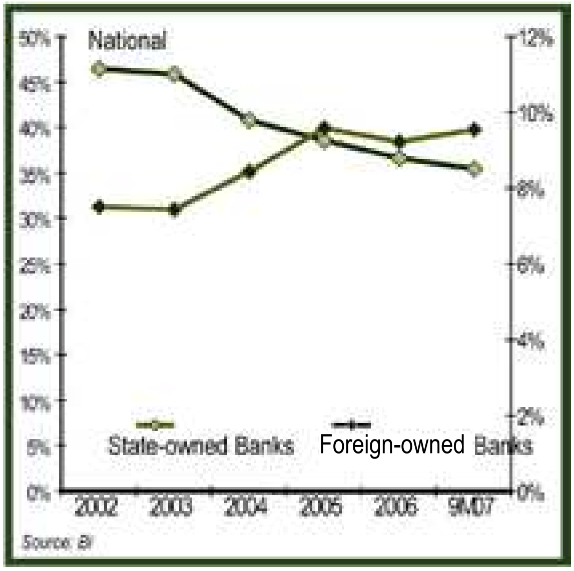
The portion of shares of third party funds (DPK) by State Owned Banks is natural. State-owned banks dominated national bank assets.

Chart 13. Share of Third-Party Funds



But, as shown in the chart below, the portion of state-owned banks toward national bank assets experienced a decrease from time to time, from 46 percent in 2002 to only 36 percent in 2006. On the other hand, foreign banks shows contradictory trend. Gradually, the role of foreign bank's assets in national scale shows positive sign.

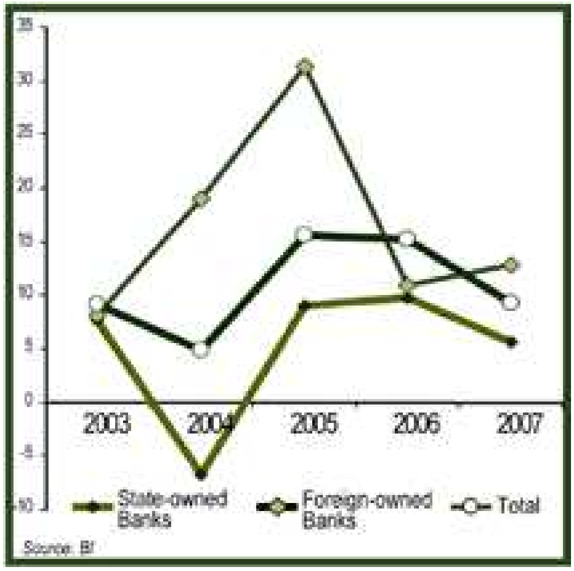
Chart 14. Share to National Banks Assets



Asset growth is one of the factors. Nationally, bank assets continue to grow, but state-owned banks do not; at one time even have a negative growth in 2004.[14]

The opposite happen to foreign banks. Their assets grow, even until it reached 31 percent in 2005.

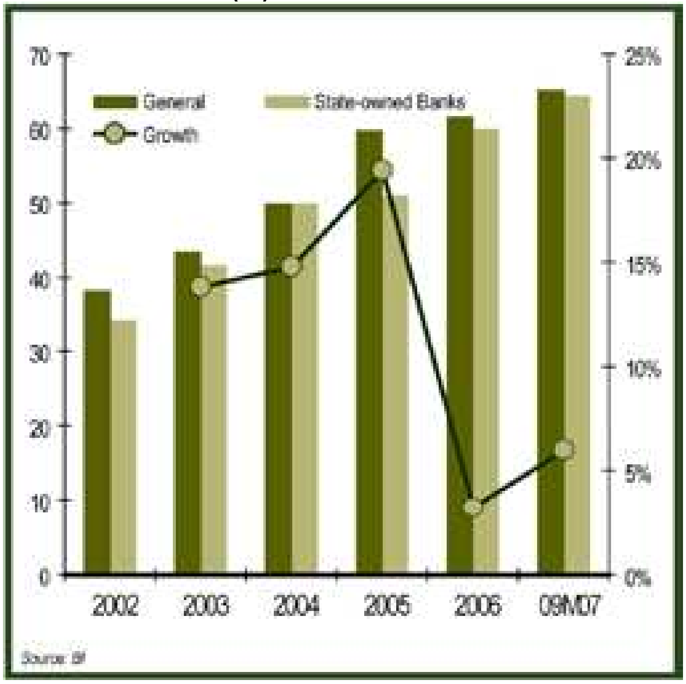
Chart 15. Assets Growth



The grown of national bank assets cannot be separated from the growth of credit. In 2006, the credit to DPK ratio had reached 61.56 percent. This shows that credit is still expansive, although the growth slowed due to the low performance of the real sector after the increase of fuel prices at the end of 2005.

14 Except in 2006, when negative growth occured 0,3 percent.

Chart 16. Credit Allocation (%)



The growth of credit is expected to continue until 2007. This is possible due to the fact that at the beginning of that year BI had announced eight new policies. One of them is the loosening of regulation on the quality of productive assets and the maximum lending limit. The growing credit gave positive impact toward people's economic freedom.

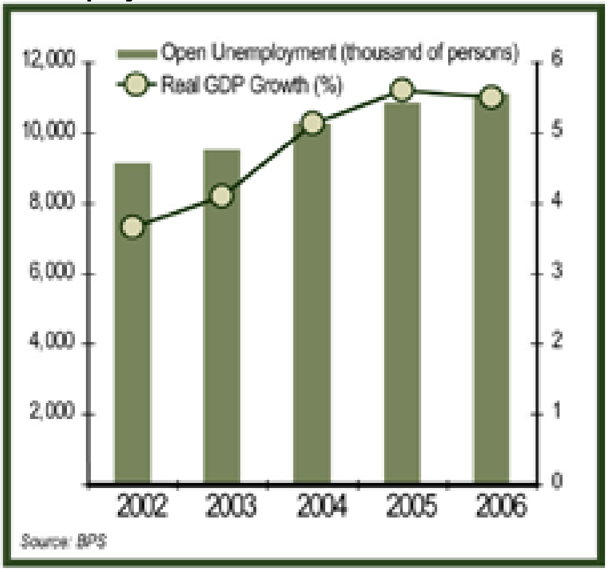
2. Labor Market

When newly elected, one of the targets of Yodhoyono – Kalla administration was to decrease unemployment rate within five years, cutting to almost half. In order to reach the target, the government had planned that each one percent of economic growth should employ approximately 427,000 to 600,000 workers, with an average growth reaching 6.6 percent a year.

Many commented that the target was too optimistic, because for the last several years the elasticity of employment had gotten smaller. Every one percent of growth only could employ 200,000 to 250,000 workers. As a result, the informal sector grew faster than the formal sector.

The chart below shows the increasing number of open unemployment, although the GDP grew. Economist called this as "jobless growth". One of the causing factors is the low production capacity used in the manufacture sector, which is only around 70 percent, far below the pre-crisis level of around 90 percent.

Chart 17. Unemployment and Real GDP Growth

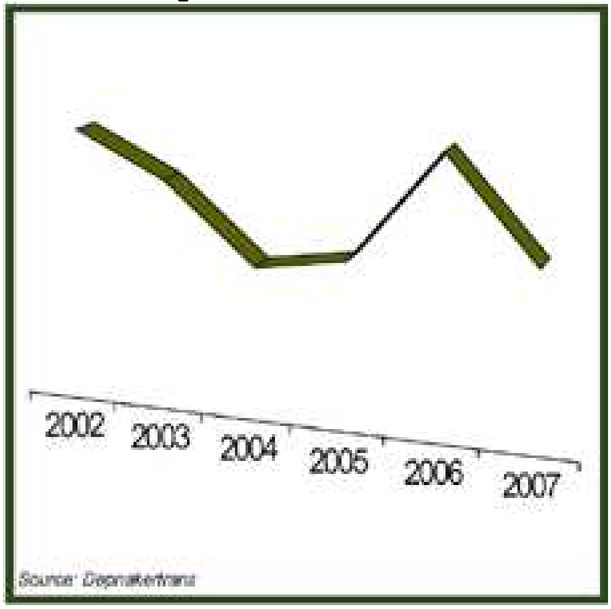


Other factor that might be the cause is the labor climate in Indonesia itself. The following are considered to be factors of constraint:

(1) Regional minimum wage (UMR)

The chart below shows the increase in Regional Minimum Wage (UMR) in 2006 which is higher than 2005. This might be caused by the government's intention to adjust workers' income that decreased in real terms post fuel price hike.

Chart 18. Minimum Wage Growth

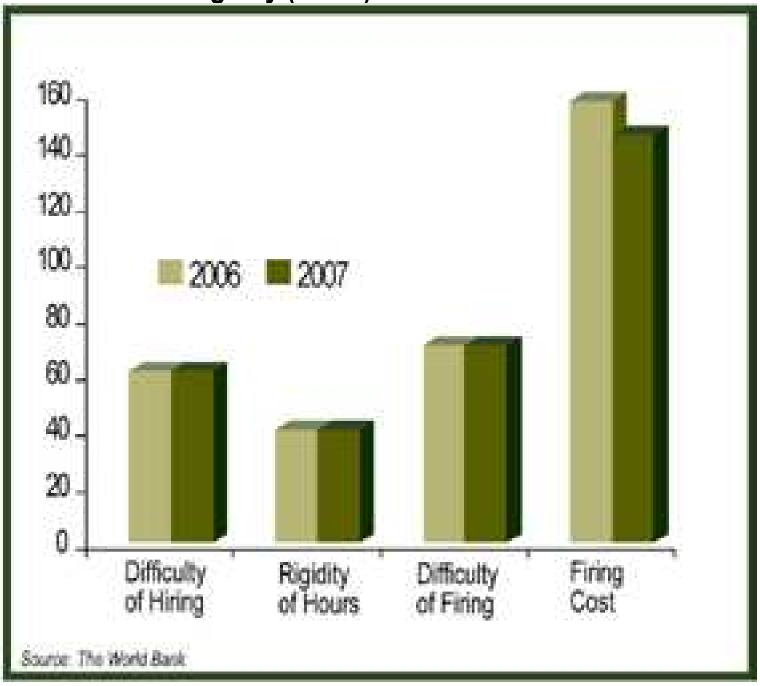


Although that's the case, minimum wage increase also bring negative impact. Research by SMERU Research Institute (2001) shows that in total, prediction of the elasticity of employment to minimum wage is -0.112 and it is statistically valid. This number shows that for each 10% increase of real minimum wage there is more than one percent decrease in employment. Women and young productive age group feel the worst impact, where employment decreased 3 percent.

(2) Market Flexibility

The chart below shows the rigidity of the labor market as a result of survey by the World Bank. As shown in the chart, almost all aspects graded do not experience an increased in 2006 compared to the previous year. Improvement only occurs on the costs to terminate employment.

Chart 19. Labor Market Rigidity (Index)



This reflects how more intensive changes are still needed. If not, unemployment rate will further increase every year against the increased number of working age. The difficulty to employ and terminate employment will only create disincentive to the business sector to expand work opportunity in the formal sector.

As a consequence, there will be more working age group that will contribute to the underground economy. This is a negative impact toward the process of increasing national productivity.

Therefore, people that benefited is only those who are already been employed in the formal sector. On the other hand, those who are yet to be employed or those who were just released from employment are parties to feel the detriment of the inflexibility of the labor climate.

Friedman had warned that minimum wage and inflexible labor market would make it difficult for volunteer workers that are prepared to work without wage. Therefore, minimum wage, especially if the trend keeps increasing, will have a negative impact on economic freedom.

3. Business Regulation

World Investment Report (2005) reported that 64,000 transnational companies are able to create 53 million direct employments. Therefore, it is no wonder that many countries make efforts to attract foreign investment to their country.

But, statistical data in the report stated that Indonesia as the lowest recipient of the funds compared to competing countries like China, Vietnam, Thailand, and Malaysia in 2004.

That fact showed that there is a decrease in Indonesia's competitiveness to foreign investors. From 1998 to 2004, investment average rate of agreement plummeted to a negative growth -8.25 percent ((Domestic investment) and -0.45 percent for foreign investment. Contrary to the New Order era, the numbers were high.

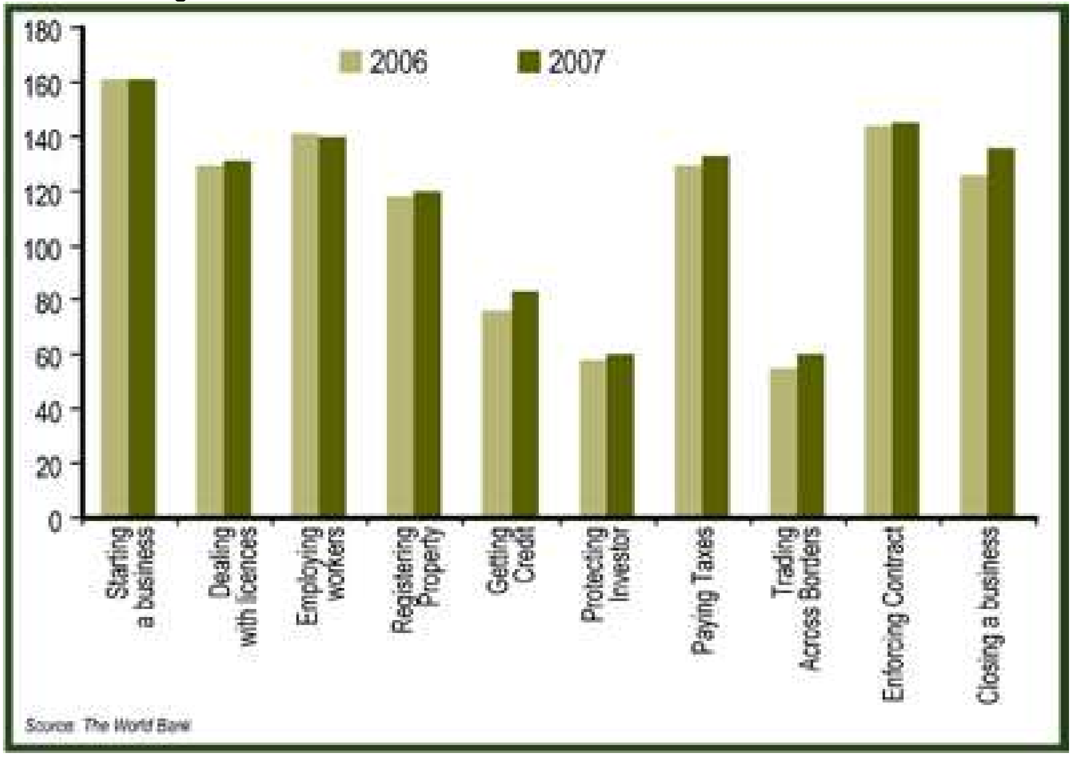
Furthermore, the deteriorating investment sentiment happened to businesses that theoretically should profit from the weakening currency. Export oriented companies, for example, the weakening currency should increase its profits and therefore encourage it to increase its investment quantity.

But, study conducted by Prasetyantoko and Thalo (2006) showed otherwise. This happened because of bad financial management strategy, and inappropriate investment climate.

This triggered the government to immediately make adjustments so Indonesia's competitiveness can improve. But, what was done was insufficient. Based on the survey conducted by the World Bank, in 2006 Indonesia only ranked 135th. That means there is a downgrade of ranking, because the previous year Indonesia was ranked 131st.

Even though several adjustments made were successful, as shown in the chart below.

Chart 20. Ease of Doing Business



The chart shows that improvements happened to almost every aspects of ease of business that was graded. But the peculiar thing is that Indonesia's rank had fallen. This happened because the business climate in other countries had improved even more, because the adjustments made were more successful.

Therefore, to reach a better rank, Indonesia must conduct more basic changes. Realizing the changes needed, the government issued a series of policy package concerning the improvement of investment climate. But, many business players, as the party that mostly interested regarding these issues are pessimistic that the government will be able to implement those policies.

If we observe more closely, the policy package offered incentives to stimulate businesses. But, the skeptical attitude always appears while keeping in mind that the government's weakness is in the implementation. This has always been proven. As an example, for months, the Value Added Tax write-off of primary commodity has not been realized until now.

CONCLUSION

From the review, we can conclude that:

1. The role of government in national economics showed a tendency to decrease. This is shown by the consumption, subsidy, income tax and state owned enterprise ratio that decreases in 2007.
2. In general, legal and political aspects are improving. Law enforcement, political stability and the better handling of corruption showed positive impact toward individual ownership guarantee.
3. The gap between money supply with Real GDP and inflation is maintained at an appropriate level. Inflation rate also improved. If the target of inflation set by the government is reached, the volatility of inflation will calm compared to the previous period.
4. International trade is improving. This is supported by the decrease in export-import tax, although there is no improvement in the length of time needed to process documents. The Negative Investment List (DNI) also shows the government's favoritism in investment, but the government still needs to provide explanations on the basic thought behind the DNI.
5. Deposits, assets and loans are still dominated by state owned banks. The total loan given has always increased. But, the contribution of state-owned banks toward the total national bank asset experiences a decreased from time to time. This happens because the low growth of assets. This has positive impact to the economic freedom climate.
6. But, labor market is still a problem. The minimum wage and the inflexibility of the labor market bring negative impact toward economic freedom climate, thus has the potential to worsen unemployment rate. For big-scaled enterprises, minimum wage policy would be overcomed by switching labor-based production to machinery-based one. However, for small and medium enterprises (UKM), minimum wage policy could only be overcomed by downsizing the number of staffs. Consequently, such policy would keep UKM underdeveloped, since their abilities for increasing production capacity.
7. In general, business regulation shows improvement. But it is still insufficient, considering other countries are showing a more significant improvement. Therefore, it is no wonder that Indonesia's business climate rank did not improve, in fact it had gotten worse. This brings negative impact toward the climate development of economic freedom.

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Nawa has also been engaged in business consulting services. For several times, he was appointed to become Lead Researcher in the assignment of business analysis and company valuations, both Multinationals and State-owned Enterprises. (*)

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ECONOMIC FREEDOM NETWORK ASIA

ECONOMIC FREEDOM NETWORK ASIA (EFN Asia)

On the initiative of the Nobel prize winners Milton Friedman and Gary Becker, the Fraser Institute in Vancouver, Canada framed a series of indicators measuring the level of freedom granted by the legal and economic system and the practical economic, finance, tax and currency policies in national economies. Based on these indicators the Economic Freedom Index was developed, which is annually published in the Economic Freedom of the World Annual Report since 1996, providing a comparison between all countries ranking them by their level of economic freedom. More than 70 economic research institutes and liberal think tanks joined the initiative of the Fraser Institute, including the Liberal Institute of the Friedrich Naumann Foundation in Berlin which publishes the Economic Freedom Report annually in Germany.

Based on findings in the report published by the Fraser Institute in Vancouver the Friedrich Naumann Foundation has supported and continuously encouraged the development of the “Economic Freedom Network Asia” to enable a wider discussion of necessary policies and framework for economic growth also as a pre-condition for poverty eradication. The Network, consisting of think tanks and research institutes from more than 20 Asian countries, cooperates to further develop the Economic Freedom Index in Asia; analyse the economic development, strengths and weaknesses of Asian countries in comparison with other regions. Since 1998 annual conferences, organized by the Friedrich Naumann Foundation, allow for the opportunity to evaluate and discuss the methods and indicators of the Economic Freedom Index from an Asian perspective and to intensify the strategic cooperation between the members.

The Economic Freedom Network Asia and its members strive to expand individual liberty in the economic sphere which will facilitate human development and economic growth. In the pursuit of its objectives, the Network provides a platform for political dialogue, public education and academic exchange in order to appeal to the public, policy advisors and political decision-makers, to broaden the public policy debate on the merits of free markets and limited governments. The Network includes organizations and individuals such as policy advisors, journalists, corporate representatives, policy makers, government officials. It also seeks partnerships with organizations outside Asia.

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