

Policy Objectives: Out of Business and On Budget

Indonesia has been called the world's largest unknown country. Certainly few Americans can locate it geographically. Even fewer know that it has a population of almost 250 million, exceeded only by China, India, and the United States. Images that come to mind relate to Aceh's devastation after the tsunami of December 2004, Bali's picturesque beaches and rice paddies, the recent spate of terrorist bombings, gamelan music, batik textiles, the Borobudur temple, the flamboyant President Sukarno, and the "Smiling General," President Suharto.

The image we would like to start with is hard to capture. It is Indonesia's remarkable transition—beginning in 1998—to a democratic society. For a country that only declared independence from Dutch colonial rule in 1945, suffered seven years of turbulence under a parliamentary democracy, and then endured thirty years of authoritarian rule under Suharto, the progress made since 1998 in building a viable democratic political system has been phenomenal and surprising.¹ An especially auspicious achievement was the 2004 election of Susilo Bambang Yudhoyono (also known as SBY) as president by more votes than any other world leader has received, including George W. Bush less than six weeks later.²

The success or failure of Indonesia's second experiment with democracy may well depend on its armed forces, the Tentara Nasional Indonesia (TNI), widely considered to be the strongest institution in the country. It was Indonesian military units, not civilian politicians like Sukarno, that won the war of independence against the Dutch, prevented the Communist Party from tak-

1. See Rieffel (2004).

2. Susilo Bambang Yudhoyono received 67.2 million votes, George W. Bush 62.0 million.

ing over in the 1960s, and created the political stability undergirding the rapid economic growth and reduction of poverty in the 1970s and 1980s. More to the point of this study, the TNI has not fully embraced the concept of civilian supremacy because the country's civilian politicians are widely viewed as incompetent and the bureaucrats as corrupt. Many officers and large segments of society harbor visions of the TNI regaining its preeminent role in the political and economic life of the country.

Two basic factors contribute to the tension between the vibrant but immature civil society that has emerged since 1998 and the military establishment, which is not large in numbers but appears to be more coherent than any other social group. One is the existence of a vast range of off-budget revenue-generating activities that make it possible for the TNI to act independently of the government. The other is popular pressure, reinforced by sixty years of history, to keep the military's share of the central government budget low—6.3 percent in 2007, equivalent to 0.9 percent of GDP. Our study focuses on both factors, which are really two sides of the same coin.

Purposes of the Study

The immediate purpose of our study is to assemble in a single source the basic information required to understand the policy challenges for the Indonesian government in the narrow area of winding down the TNI's business activities and in the broad area of putting the TNI on full budget funding. Although business activities have played an important part in the life of the Indonesian Armed Forces from the moment Sukarno and other nationalist leaders declared the nation's independence from colonial rule by the Netherlands in 1945, the first major study of these activities did not appear until 1998.³ Since then the subject has been taken up in more than half a dozen books published in English and in Bahasa Indonesia (the official language of Indonesia), as well as in dozens of academic papers, short opinion pieces, and in-depth press reports. Rather than attempt to produce new historical or empirical information, we have built our study on the wealth of information that is already available.

By highlighting the complexity of pursuing reforms in this area, we hope the Indonesian public will more clearly see why it will be difficult to make meaningful progress here in the next two to three years. Equally important, we hope that policymakers in Indonesia will gain a better idea of fruitful steps to be taken, and that foreign governments eager to assist Indonesia in con-

3. Samego and others (1998).

solidating democratic governance will be able to target their concerns more sensibly and contribute support in more effective forms.

Our study differs from preceding ones primarily in that it looks forward more than backward. It is not a historical or investigative study but a policy analysis focusing on thirty issues inextricably linked to the process of weaning the TNI from its many sources of off-budget revenue and putting the TNI fully on budget (box 1-1). The government's challenge here can be likened to an algebra problem. It takes three simultaneous equations to solve a problem with three unknowns. In this case, however, there are thirty unknowns. Inevitably, the related policy decisions made with respect to the thirty issues will have to be sequenced. Making them all at once is not feasible. As a consequence, the benefits of making sensible choices may not be visible until a "tipping point" is reached well along the way and momentum develops to carry the process to a successful conclusion.

Another point to bear in mind is that these are not simple black or white issues. As with most policy issues, there are several options, each attended by pros and cons, which in turn depend on assumptions about which reasonable people can differ. In other words, the Indonesian government is navigating the course toward full budget funding for the TNI without precision instruments. Achieving the goal by 2009 appears to be impossible. Even a five-year timeline would require an improbable combination of good judgment, good discipline, and good luck. Full funding by 2012 or 2015 may be feasible.

Why Is Getting the TNI out of Business and Fully on Budget Important?

A team of Indonesian military experts led by Danang Widoyoko has clearly set forth the rationale for ending the military's business activities.⁴ First, the freedom of action the military derives from an independent source of funding weakens the ability of the government to set national goals and determine the means of achieving them. Second, the time and effort absorbed by managing and engaging in business activities diverts individual officers and soldiers from their constitutional duty of defending the nation against external threats and enhancing domestic security.⁵ Third, the military's business activities cre-

4. Widoyoko and others (2002, pp. 68–69).

5. According to the Constitution of 1945, chap. 12, art. 30, as amended: "(2) The defense and security of the state shall be conducted through the total people's defense and security system, with the Indonesian National Military (TNI) and the Indonesian National Police (POLRI) as the main force, and the people as the supporting force. (3) TNI, consisting of the Army, Navy and Air Force, as an instrument of the state has the duty to defend, protect, and maintain the integrity and sovereignty of the state."

Box 1-1. List of Policy Issues for Getting the TNI out of Business and Fully on Budget

Military Businesses (chapter 6)

- Issue 1. What general policy will the government adopt and enforce toward the business activities of government agencies across the board?
- Issue 2. How will government policies with respect to military foundations be changed?
- Issue 3. How will government policies with respect to military cooperatives be changed?
- Issue 4. What policy will the government adopt on the provision of security services by military units?
- Issue 5. What policy will the government adopt on the commercialization of state assets owned or controlled by military units?
- Issue 6. What policies will the government adopt with regard to military involvement in illegal or criminal income-generating activities?
- Issue 7. What approach will the government take to implementing Article 76 of Law No. 34 of 2004?

A National Defense and Security Strategy (chapter 7)

Issues Related to Design

- Issue 8. What are the main external threats and what priority should be attached to each one for the purpose of determining the TNI's force structure?
- Issue 9. To what extent will Indonesia participate in regional security arrangements?
- Issue 10. Will the national defense and security strategy be threat-based or capacity-based?
- Issue 11. What will be the respective roles of the TNI and the National Police (Polri) in dealing with threats to public order from domestic terrorists, regional rebellions, and communal violence?
- Issue 12. What role will the TNI play in protecting natural and strategic resources?
- Issue 13. What role will the TNI play in peacekeeping operations in other countries organized by the United Nations or other international bodies?

Implementation Issues

Issue 14. How will the new TNI doctrine evolve?

Issue 15. What will be the relative strength of the army, navy, and air force?

Issue 16. What will be the role of other forces that can bear some of the burden of internal security?

Issue 17. Will the army's territorial command structure be replaced or modified?

Issue 18. How will intelligence activities be organized, how should official secrets (classified information) be protected, and what information should the public have access to?

Issue 19. Will a new military justice law provide effective disincentives for the TNI to continue engaging in business activities?

The Military Budget (chapter 8)*Major Budget Parameters*

Issue 20. How rapidly will the government allow the military budget to grow over the next five to ten years?

Issue 21. To what extent will regional (*daerah*) governments be permitted to provide financial and other support to the military?

Issue 22. To what extent will the efficiency of the military budget increase?

Issue 23. How much military equipment will be procured from the domestic defense industry?

Issue 24. How much foreign aid will the military be allowed to receive?

Issue 25. How will the government's policy change regarding off-budget financing for the military?

The Welfare of the Soldiers

Issue 26. How will the structure of civil service salaries evolve and will the military salary structure continue to be linked to it?

Issue 27. What provisions will be made for military personnel pensions?

Issue 28. What provisions will be made for military personnel housing benefits?

Issue 29. What provisions will be made for the health and education of military personnel and their families?

Issue 30. What benefits will be made available to disabled soldiers and their widows and orphans?

ate distortions in the nation's economy that lower productivity, misallocate scarce resources, and thereby impede growth. Preferential access to bank credit is an especially corrosive feature of military businesses.

Six months before we began this study, we proposed four sensible principles for managing the military's budget: respect the supremacy of the civilian government in setting priorities and making rules, follow rules rather than operate on a discretionary basis, reinforce transparency and accountability, and strengthen coordination among the government agencies that share responsibility for defense and security (notably the military and the police).⁶

The open debate over national priorities in 1998, in the aftermath of the collapse of the Suharto regime, seemed to suggest that ending the military's role in the economy, "returning the military to the barracks," was high on the country's list. At the beginning of 2007, however, there was scant evidence that transferring to the government the businesses directly or indirectly controlled by the military was one of the top twenty public policy issues.

What Are the Risks of Ending the TNI's Business Activities or of Failing to End Them?

Perhaps the biggest risk in ending the military's business activities is that some officers and soldiers will turn to illegal activities to maintain their current standard of living. This risk can be mitigated by increasing budget-funded TNI salaries and allowances and by gradually phasing out businesses instead of adopting a shock approach. Another risk is that the additional funding required to put the military fully on budget will squeeze out other programs (education, health, infrastructure) that are critical to the country's political stability and economic growth. If allowed to continue its business activities, however, the military might become a destabilizing force in the political life of the country.

Where Are the Data?

Many readers will be frustrated by the small amount of data produced by our study concerning the military's off-budget revenues and expenditures. Unfortunately, reliable data of this nature do not exist in an accessible or reliable form. Although we could have collected anecdotal information and added it up, interpolating to fill in the blanks, we declined to do so because it would inevitably be backward looking and still not produce an accurate picture. We

6. Pramodhawardani in UNSFIR (2005, p. 27).

did, however, devise a “methodology” for estimating the amount of net income generated by the TNI’s off-budget activities in 2006 “for operational purposes,” which is presented in chapter five.

More important, we have adopted an approach to on-budget and off-budget income and spending that does not depend on data. In any case, the military alone can produce such information, and it shows no indication of being close to doing so. Furthermore, broad political, economic, and cultural forces are combining to steadily shrink the TNI’s off-budget income. Therefore we see no advantage in waiting until credible data are available and have instead directed our efforts toward identifying steps that can be taken now to bring Indonesia closer to fully funding its armed forces.

Conclusions

Two main conclusions emerge from our study. First, the amount of money TNI business activities generate “for operational purposes” is much smaller than is commonly believed. Second, it is not feasible to put the TNI fully on the budget by 2009, the deadline set in Law 34 of 2004.

According to conventional wisdom, Indonesia’s armed forces have for years obtained 60–70 percent of their funds from a wide range of off-budget business activities and the remainder from the central government’s budget. While this estimate may have been accurate at some point in the past, we believe that the net income generated by the TNI’s off-budget activities in 2006 and available “for operational purposes” was equivalent to only 1.5–3.0 percent of the government’s defense budget for that year. This low estimate results from two critical assumptions:

—Only the net income (profit) of its business activities is “available” to the TNI, not its gross revenues (total sales before expenses).

—Not all of the net income from its business activities is used “for operational purposes.”

One assumption has pushed our estimates up: income from off-budget activities is supplemented by income from a few nonbusiness activities, especially “gifts” and “procurement commissions.”

An important policy implication of our first main conclusion is that the budget increase required to replace the off-budget funds now flowing to the military is much smaller than is generally assumed. Most emphatically, however, this does not mean that the problem of military businesses has been overblown or should remain on the back burner. On the contrary, we believe that getting the military out of business is essential to accelerating economic

growth in Indonesia, consolidating its vibrant but still-fragile democratic system, and achieving a more just and prosperous society.

As already mentioned, 2009 is an unrealistic target for this endeavor. The only way the military could be fully on the budget by then would be to reduce its role in the defense and security of the nation. For example, if it is assumed that Indonesia faces no “conventional” external threats that would have to be repulsed by conventional military units (infantry and artillery battalions, submarines and destroyers, fighter squadrons, and so on), then the budget required to maintain the current number of military personnel at their current level of operational readiness may not be much larger than its present level. Or if it is assumed that all internal threats related to secessionist movements, communal violence, terrorism, and the like will be addressed by the National Police, then the current budget may be adequate.

Few military experts, government officials, politicians, or segments of the voting population would subscribe to such a modest role for the TNI. Realistically, serious options range from a “minimal essential force” that may be achievable in the medium term to a somewhat more robust force. An “ideal” force, on a par with that of Malaysia or Thailand, for example, appears to be out of the question in the next ten to fifteen years.

Given the extremely low operational readiness of today’s TNI, not to mention the obstacles to efficient planning, budgeting, and procurement, it appears impossible to raise the operational readiness of the TNI’s existing forces to the 80–90 percent level by 2009. It may be possible to do so by 2012. Equipping and training a restructured TNI to be more effective in supporting the defense and security objectives of the democratically elected government may also be feasible by 2012 but would presumably be more costly.

Four large obstacles stand in the way of putting the TNI fully on the budget by 2009. First, the military culture, which is more in the spirit of the Suharto era than the Reformasi (Reformation) era, reinforces business activities. Pecuniary incentives also play a powerful role in maintaining these activities. Second, the military lacks a credible strategic plan or framework and thus is loath to move away from its business orientation to a more professional one. Third, as long as the country’s economic growth rate is stuck in the range of 5–6 percent a year, the central government will be on a tight budget. Fourth, the democratic system introduced in stages after Suharto’s resignation has been giving high priority to education and other social sectors over defense and security.

Some further conclusions relate specifically to the TNI’s business activities.

—The main benefit of the military’s business activities is employment, not only for military personnel but also for their family members and friends. These activities are akin to a public sector employment program, and there is no reason to believe that the TNI is a more efficient employer than other public sector agencies.

—Military businesses are expenditure-maximizing rather than profit-maximizing entities; as such, they make important contributions to the welfare of military personnel who might otherwise engage in more harmful behavior.

—Almost all public sector bodies have created “foundations” that function as holding companies for various business activities. Instead of being instruments to promote social welfare, they function as money-laundering mechanisms in a way that is impossible to reconcile with good governance. Although it may be possible to improve the transparency and accountability of the military’s foundations, closing them down or separating them meaningfully from individual commands will be resisted as long as other foundations in the public sector are allowed to do business as usual. Even if the process of dissolving TNI foundations begins immediately, it will take some time because settling the claims of nonmilitary shareholders and creditors will be difficult and time-consuming. Nonetheless, the TNI could set an example by leading the Indonesian government out of this wilderness.

—Cooperatives constitute another subsector of military businesses. Most of them are small, serve useful social purposes, are more transparent than the foundations, and are more accountable to their members. Closing them down would probably incur heavy costs in morale that would outweigh any economic efficiency and military professionalism gained by doing so. As for the few cooperatives that have grown into substantial business conglomerates, any abuses there could be greatly reduced by separating them from their host commands, putting them into the hands of experienced civilian managers, and increasing the transparency of their operations.

—Putting on budget the revenue from commercialization of state assets is another particularly attractive area of reform. Currently little if any of this revenue appears to be reflected in the central government’s budget, despite various budget laws and regulations requiring that it be included. Since almost all other ministries and agencies generate off-budget revenue from the commercialization of state assets, it may be difficult to put the military’s revenues from this source on the budget until comparable discipline is applied to the rest of the government.

—A strong case also exists for putting on budget the income generated by the military's security services, such as those provided for Freeport-McMoRan Copper & Gold in Papua until early 2006.

—For better or worse, Article 76 of Law 34/2004 has created a benchmark for progress in this area of military reform. With its credibility at stake in the elections of 2009, the SBY government is running out of time to resolve the issues that have delayed the implementing regulation called for in Article 76 and visibly begin transferring individual business units to the government, privatizing them, or closing them down.

The pace of progress in getting the TNI out of business will be heavily influenced by the evolution of the defense budget. The size and composition of the defense budget will in turn depend on many factors.

—The government is in the process of reforming the civil service, particularly restructuring the compensation system to make it less discretionary and more closely linked to performance. Reform of the TNI's compensation system could lead or lag behind this effort, but probably not by very much.

—It is unrealistic to expect the national defense and security strategy scheduled to be issued in the first half of 2007 to be fully credible. A half-credible strategy could provide a sufficient basis for making sensible choices with respect to many of the issues we have highlighted in our study.

—The territorial command structure of the army will be a major obstacle to reducing the TNI's access to off-budget income. Generating off-budget income is deeply rooted in the daily activities of the personnel in the territorial commands. It may not be possible to bring the military establishment up to a professional level until the territorial command structure is modified or replaced with a structure more clearly linked to defending the nation against critical external and internal threats.

—Studies commissioned by the Ministry of Defense could lay the groundwork for more effective use of budget resources for improving the welfare of soldiers, especially in the areas of health care, education, and the support of crippled soldiers, widows, and orphans.

—Well-targeted technical and financial assistance from foreign countries and international institutions could help move the TNI out of business and on the budget at a faster pace.

The Flow of the Study

Our analysis opens in chapter 2 with a word about the global and domestic contexts of TNI financing. Several developments at the international level

merit attention: recent geopolitical changes, which have reduced the need for a military structure designed to defend against conventional attacks; the unlicensed exploitation of Indonesia's forest and marine resources, which is its greatest external threat today; the growth of regional cooperation in Southeast Asia; the global trend in strengthening civilian control over the military; and technological advancements. Another important consideration is the scope for foreign assistance in enhancing the military's operational capacity and professional character.

On the domestic front, the business activities of the military are part of a decades-old cultural pattern that has become deeply embedded in almost every corner of government. It is unrealistic—especially in view of the fragility of Indonesia's eight-year-old democracy—to expect the military to alter this pattern as long as it remains strong in the rest of the public sector, and indeed in the private sector as well. To complicate matters, there is an uneasy and unstable division of responsibilities between the military and police for containing terrorism, separatism, and ethnic/communal unrest. In addition, constraints on the budget itself have historically provided the basic rationale for the military's engagement in an immense range of business activities.

The main body of the book is divided into two parts focusing on the twin goals of getting the TNI out of business and fully funding a professional TNI from the central government budget. As pointed out in chapter 3, reform cannot be attempted without an understanding of the history of military business since independence, which evolved in four stages (for a brief account of the history and structure of the military itself, see appendix A). During the struggle for independence (1945–50), localized income-generating activities by the disparate units fighting the Dutch became critical to their operational effectiveness. In the Sukarno era (1950–65), the military's role in the economy expanded sharply when most foreign-owned businesses were nationalized and military officers were assigned to manage many of them. As a share of domestic output, the value added by these business activities probably peaked in the middle of the Suharto era (1965–98) and then began a slow decline, squeezed out by the growing business ambitions of Suharto's family and friends. A subsequent blow was the financial crisis of 1997–98, which destroyed the banking system, wiped out many “modern” (military and non-military) businesses dependent on access to large amounts of credit, and gave birth to the Reformasi era (1998–). Antimilitary sentiment since then has contributed to further erosion of TNI businesses.

The military's business activities in all spheres—formal, informal, and legal—are laid out in chapter 4, and our “methodology” for estimating the size

of the TNI's off-budget income in 2006 follows in chapter five. The calculations behind these estimates appear in appendix B.

Chapter 6 examines the process of implementing Article 76 of Law 34/2004, which requires that all of the military's business activities be transferred to the government by 2009. The challenge of meeting the Article 76 deadline falls squarely on the shoulders of President SBY, who may be running for reelection in 2009. This chapter also raises seven of the thirty policy issues highlighted in our study.

Turning to the goal of full funding, chapter 7 notes the current policy vacuum and the need for at least some elements of a credible national defense and security strategy before the budget amounts for full funding of the TNI can be determined. The discussion then focuses on six policy issues related to designing such a strategy and another six related to its implementation.

Chapter 8 takes up the current military budget, projected out to 2012 for three scenarios: base case, low growth, and high growth. Six of the relevant policy issues here relate to major budget parameters and five to the welfare of the soldiers.

Reluctant to prescribe specific policy measures because of the nature of our study, we nevertheless have been persuaded to offer a few general observations and highlight some implications. We do this in chapter 9, the last part of the book.