BY HILTON L. ROOT

SUHARTO'S TAX ON INDONESIA'S FUTURE

The collapse of Suharto's Indonesia offers many lessons about the nature of economic development and the role development assistance can play in facilitating economic change. This populous, resource-rich country was the flagship model of assisted development. The World Bank endorsed the Indonesian model with $25 billion over three decades. International investors interpreted the Bank's enthusiasm to lend as a sign that Indonesia was a prime investment environment. Foreign investment peaked at $18 billion in 1996.

Then, something went terribly wrong. Since November 1997 the currency plummeted, losing about 80 percent of its value against the dollar. Per capita income has fallen from $1,300 to $340, wiping out several decades of economic progress. The economy will do well this year if it declines by only 15 percent. Even after the IMF managed to get its wish list of reforms included in its loan package, the rupiah continued to collapse.

{continued}

The Era of Rapid Development

The depth of Indonesia's problems continues to surprise international monetary officials who had been very proud of Indonesia's accomplishments under Suharto. There was much to be proud about. As Indonesia's economy grew, poverty fell. Various indicators of progress, such as electrification, phone service, and road paving, made a strong positive impression that growth was broadly shared.

The first three five-year development plans were almost exclusively dedicated to rebuilding infrastructure and developing the rural sector. The first plan emphasized rural and agricultural development, self-sufficiency in rice production, and modernized irrigation facilities. The second and third five-year plans, buttressed by the oil boom, prioritized rural infrastructure. The emphasis continued to be rice production, expanding physical and social infrastructure—roads, bridges, school buildings, health facilities—and promoting human resource development through universal primary education.

By the late 1970s the government's development programs began to show significant results. From a high of 60 percent in 1970, the proportion of the population in poverty dropped to 28.6 percent in 1980. Income inequality steadily improved, with the Gini index declining from .40 in the late 1960s to .30 in the late 1980s.

An expenditure program, INPRES, which institutionalized a formula for allocating revenues among various levels of government (central, provincial, district, and village), was introduced to reduce interregional disparities. It provided flexible direct subsidies to equalize the infrastructure of all provinces. (Nevertheless, today INPRES has many critics, such as the inhabitants of oil-rich Riau who claim that their province has not prospered from the $3 billion in oil revenues it provides Jakarta annually.)

Indonesia was different from other oil-exporting nations because it used oil revenues to create income-generating opportunities for the rural poor rather than for pure transfers. Unlike in South Asia and Latin America, improving the distribution of income was not the direct goal; promoting growth was the objective. The outcome was improved productive capabilities, greater access to markets, and enhanced human capital.

What Price Growth?

On the merits of its poverty reduction record Indonesia was held up as a model, allowing for the general forbearance of poor performance in other areas of development administration. Compared to other resource-rich countries, Indonesia had channeled more of its oil revenue into productive activities. However, compared to other East Asian countries, Indonesia's leaders did little to overcome basic weaknesses in its investment environment. Property rights protection was the weakest in the region, as was the quality of the bureaucracy. The World Economic Forum consistently ranked Indonesia's business environment below the 50th percentile among a group of 14 newly industrialized countries. Transparency International ranked Indonesia as one of the most corrupt of 50 countries in its annual ratings. As a result, private investment as a share of GDP was lower in Indonesia relative to other high performers, although the private investment ratio was higher than in oil-rich Nigeria or Venezuela.

Transparency has rarely been a factor in resource-based development. Property rights were weak during the California gold rush and in the early days of oil exploration in the United States. But other sectors of the U.S. economy were transparent and rule-bound, so private markets developed in a broad range of industries and services. This was not so in Indonesia.

The quality of Indonesia's civil service resembled that of other countries that had not developed successfully. Indonesia's development programs succeeded when they enjoyed direct and constant supervision by the president; but without direct supervision, failures in implementation were common. An example is Indonesia's failure to implement privatization in 1996–97 because government agencies were unable to credibly organize auctions. Most of Indonesia's 4 million civil servants are part of the political party Golkar and are selected for political loyalty, allowing Golkar to crush its rivals. The civil service provides an important part of the voting population and it campaigns in the villages to mobilize support for the party. Their reward is their ability to collect bribes while supervising government projects. Demoralization was commonplace for lack of a well-defined, competitive career path with a reward for a job well done. Corruption was hard to avoid because civil servants had to pay a tax to foundations controlled by the president.

The central government forced districts to accept village administrators chosen by the nation's official party. With no accountability to the people they governed, answering only to Jakarta, these "little Suhartos" in the villages could buy and sell village land. Many reputedly bribed their way into office and recouped their expenses by misusing village funds and fraudulently resolving land conflicts.

When Transparency International ranked Indonesia among the most corrupt countries in the world, Indonesian officials retorted, "How can you argue with our consistently high growth rates?" Several reasons explain why corruption in Indonesia did not seem to deter business. The country's growth is based largely on resource extraction, so it did not have to stake its name on providing a transparent business environment. Corruption allowed elite business interests to trample on the rights of rural society and thereby exploit the forest and mineral wealth without having to succumb to the niceties of the law or due process. The system of corruption was highly centralized so that redundant extraction could be eliminated and so that people at the top could ensure that bribe payers had their informal agreements enforced. Investors, as a result, found the business environment as conducive to profit making as the reputable and legalistic Singapore. In effect, profit margins in Indonesia were among the highest in the world despite the corruption because a lack of legalism allowed for unmitigated resource extraction and exploitation of labor.

> *"When Transparency International ranked Indonesia among the most corrupt countries in the world, Indonesian officials retorted, 'How can you argue with our consistently high growth rates?'"*

High growth rates justified indifference to mismanagement, allowing multilateral donors to disregard poor governance as reflected in rampant corruption, an outdated commercial code, and an inept judicial system. Never a harsh word was heard from the two principal powers and donors in the region; both Japan and the United States have highly valued the status quo in Indonesia. Japan likes access to cheap natural resources and an increasing consumption of its industrial products. Since most of the deals were secured through networks, personal ties, and political connections, Japan did not see any reason to encourage a change in leadership that might place those deals in jeopardy. The United States liked stability in Indonesia because of the country's strategic importance as an anticommunist bastion during the Vietnam War, and likes it now as a counterweight to China's military strength in the region.

Indonesia had another charm to endear its donors. The country's technocrats, who interfaced with international donors, were highly regarded and held their positions for long periods of time. Hence, the country embodied the donor ideal of economic policymaking without politics. Responsible macroeconomic management—including stringent controls on the budget, depreciation, and convertibility of the currency—resulted from technocratic counsel. Inflation decreased from triple-digit levels in the 1960s to single-digit levels in the 1980s. With inflation and poverty levels going down and the currency stabilized, the economy could absorb huge flows of funds from donors anxious to justify high levels of lending.

Two crises occurred that allowed Suharto to signal his commitment to technocratic solutions, even when close political allies were involved. In 1975 the state-owned oil company failed to meet its foreign debt obligations, and in 1982 oil prices collapsed. In both cases Suharto relied upon technocratic counsel to get the economy moving. Requiring only the consent of top leadership, effective macroeconomic policies did not require wholesale reform of the bureaucracy. The microeconomy was in the hands of the generals; technocrats managed the macropolicies and thus did not threaten the dissemination of spoils.

However, reforms only occurred during periods of economic crisis, when the flow of financial resources was threatened. Changes had to be prompted by product or factor markets. Internal discipline was lacking. The technocrats' advice was valued when their ideas were needed to get out of a crisis, but no process existed for continuous innovation on the basis of internal feedback mechanisms.

In any society, informal decision-making processes do much of the work of filtering or framing issues, generating a range of alternative solutions and placing new issues on the table. Indonesia had none of the advantages of informal social processes. As a society dominated by one decision maker, it lacked the ability to resolve or identify issues to continuously upgrade the policy environment. In Suharto's Indonesia, social agreements could be achieved in only one direction. Those outside the small decision-making hierarchy at the top had no way to signal their agreement or to put their issues on the agenda. With decisions only being made at the top, social habits of political persuasion were irrelevant.

Unlike East Asia's high performers, Indonesia featured practically no organized coalitions that were part of the decision-making matrix with power to influence social choice. The high-performing East Asian countries developed a governance framework in which alternatives could be articulated. Business councils met with top political leadership to shape fiscal and trade policies as well as to monitor bureaucratic performance. Similar decision-making bodies were not allowed to flourish in Suharto's Indonesia. Informal organizations risked censure and sanction; even random conversations between individuals could result in punishment. With criticism silenced, friends of the regime could get their projects funded even when market sense was absent. Inefficiencies in the allocation of resources, numerous white elephants, and mismanaged state-run industries all reflected a lack of accountability of those at the top and an absence of informal processes or networks at the bottom. Major investment decisions reflected the interests of a single clique, ultimately a single family. In politics, coalition dynamics that might enrich policymaking were absent; the scholarly debate in Indonesia's universities was frozen; its think tanks could address issues only obliquely. It was effectively impossible to get an objective assessment of the costs to the economy of any particular piece of economic regulation.

Without durable economic institutions that established clear rules of the game, two routes to wealth existed, both of them informal: Team up with the Chinese or sign up with the president's family.

A system of informal business relations evolved in which the economically experienced ethnic Chinese ran the businesses, and the politically dominant military used its clout to secure regulatory arrangements and its muscle to ensure a compliant labor force. Owners ensured a docile labor force by keeping military commanders on the boards of firms (to which they contributed no managerial expertise). This lucrative partnership left many senior officers financially secure. The approximately 6 million ethnic Chinese eventually came to dominate the business of the archipelago. Although they made up 3.5 percent of the population, they controlled more than 70 percent of the non-landed wealth, 68 percent of the top conglomerates, 80 percent of total assets of the top 300 conglomerates, and nine of the top 10 private sector groups. Nevertheless, their assets were trivial compared to those acquired by the president's family.

Because of the state's inability to ensure functioning markets, the ruling family gained vast leeway to extract value from proposed economic activity. With its legal system and commercial codes unable to sustain modern business transactions, investors depended on administrative or executive discretion. The result was corruption and opportunism. To overcome the government's inability to enforce rules, business relied on connections to some important agent of the state, such as the president's family. Would-be investors needed the political muscle of Suharto's family and cronies to enforce property rights, overcome regulatory uncertainty, and ward off rampant bureaucratic malfeasance and graft in the civil administration. Although their involvement in a deal created value for these potential investors, much of their wealth simply came from using the family name to gain access to state-bank credits and government concessions.

The president's empire includes toll roads, satellite communications, broadcasting, car manufactures, power projects, domestic airlines, taxi services, and water supply utility trading ventures. The state-owned oil company alone had 143 contracts with firms controlled by the president's family. In many of these areas the family injected little management expertise or capital; they simply made it possible for friends to get government contracts and licenses. Since multinationals needed a local partner, the partner of choice was Suharto's family.

Jealousy was building up against both the Chinese and the first family, but it was liberalization that unleashed its expression. With resentment stewing, liberalization heightened tensions.

The Decomposition of Suharto's Authority

Indonesia's friends believe they have won a significant debate about how to help Indonesia. They have secured more than $50 billion in assistance by convincing members of the international community concerned with economic policy that economic security must be established before political order can be reformed. But are they merely restating the assumptions that caused the country's economic collapse? To win their argument, they are perpetuating several misleading myths.

Myth One: *Popular Unrest Brought Suharto Down*

Suharto followed a global trend and opened up the Indonesian economy in the mid-1980s. To gain greater access to foreign funds, he undertook tax reform and liberalized trade and financial markets. Before, a complex licensing regime had determined access to the market, making investors dependent on political connections. By depriving Suharto of many of those powers, liberalization created economic interests that he could not control and which grew to resent his domination of the economy. As a result, his authority began to decompose. By 1995, loose talk about Suharto's personal grip on the economy started to circulate, even among trusted advisers whose lips had been sealed earlier. Discontent among the elite nurtured the student movement.

During the riots preceding Suharto's resignation, eyewitnesses reported that looters were being ignored by the military. Many even observed the army withdrawing as the rioting expanded and asked why the army did not act sooner to restore order.

The army was going through an internal tug-of-war that escalated shortly after Suharto departed with a purge by General Wiranto. A unified elite easily could have suppressed the fledgling student movement. However, as the president's authority began to disintegrate, members of both the military and the technocracy defected, wanting to distance themselves from the regime. Suharto was the last one to know about the desertion of his troops.

Financial donors hope that by giving the government some breathing room, they can help improve the welfare of the population. They should consider that the present government owes little to the people in the streets. Hence, we can expect more infighting among elites. The problems of collusion, nepotism, and corruption have only just begun to surface as the politicians, bureaucrats, and generals jockey to protect and even expand their empires. Many well-connected business groups are espousing a position of economic nationalism in order to justify the return of protectionist policies. Future political conflict will center on protecting the spoils of three decades of monopolies, privilege, and corruption, not on extending economic opportunities to Indonesia's poor. Much of that conflict will be concentrated within the national political party, Golkar, which the Suhartos will try to transform into a vehicle to protect their family's wealth.

Upon taking charge in 1967, President Suharto emphasized shared growth to deter communism's strength throughout the archipelago. In the 1980s, with communism eliminated and tight control over the military established, Suharto increased his share of the take, leaving only crumbs for other members of his coalition, especially the military. Liberalization reduced their once lucrative role as facilitators. With democracy and all institutions of accountability crushed, he could divide the spoils among an increasingly smaller inner circle. Support for liberalism has its roots in a desire by those left out of the circle to overturn Suharto.

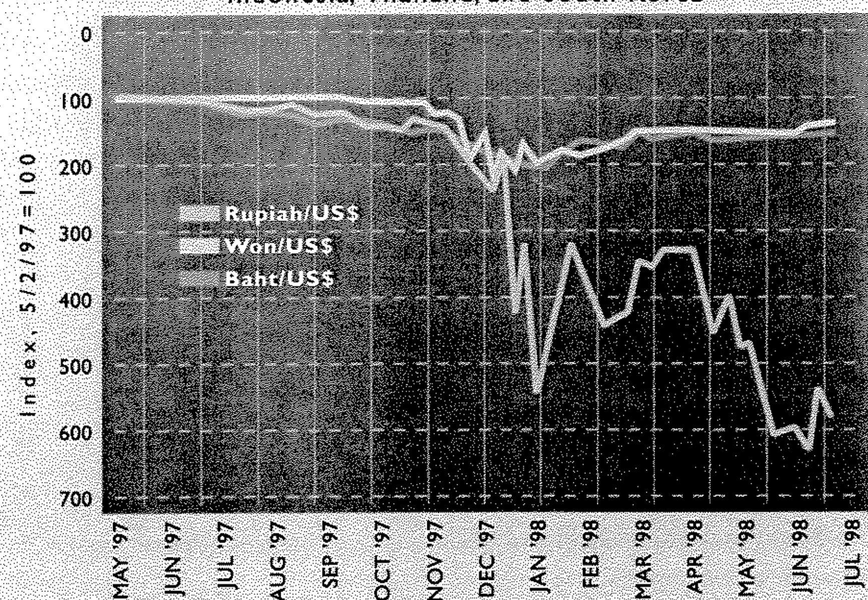
Now there is talk of the need to curtail the expansion of the international financial system or to subject cross-border capital flows to some kind of international governance. This is unfortunate. Lacking institutions to make leadership explicitly accountable for economic performance, reform has come from international financial markets. The capital market imposed the discipline that the internal control systems lacked. By buying into the myth that Indonesia can be stabilized economically without political reform, financial donors are contributing to the source of the problem: an unaccountable political leadership.

"By buying into the myth that Indonesia can be stabilized economically without political reform, financial donors are contributing to the source of the problem: an unaccountable political leadership."

Myth Two: *The Problems Could Not Be Foreseen*

Believing that Indonesia was on a sound path to development, financial donors point to unexpected circumstances

FIGURE 1
Weekly Exchange Rates
Indonesia, Thailand, and South Korea



Source: Datastream

to explain Indonesia's collapse. Unexpected circumstances are a fact of life, and all leaders face crisis; but some respond more successfully than others. Indonesia failed to respond to its economic challenge because its political system was frozen.

In fact, the same unexpected circumstances that created catastrophe in Indonesia were prevalent throughout East Asia. Foreign lenders found local borrowers using pegged local currencies who were willing to arbitrage relatively low foreign interest rates against higher local rates to make short-term loans. This allowed a proliferation of intermediaries with funds to lend chasing very few good projects. But Indonesia's banking sector, the region's most politicized, is also the weakest. Political opportunism allowed two kinds of abuse to develop in Indonesia's banking system. First, standards of accountability were notoriously flouted so that funds could be channeled to friends of the regime. Nonperforming loans to regime cronies account for much of the current private debt. A list of bad debtors, leaked in 1994, revealed that eight of the top 22 borrowers at the state banks were behind on 40 percent of their loan repayments. Suharto's children and their associates were high on the list of delinquent borrowers. Second, internal corruption within the banking system was tolerated. Loan supervisors typically would collect 10 or 15 percent of a loan up front as a kickback. In both cases projects were not chosen on their economic merits. Adverse selection resulted in the funding of highly risky projects or of projects enjoying political protection. Banks did not develop skill at assessing the risk of particular investments because such skill was unnecessary.

Myth Three: Economics, Not Politics, Is the Source of the Problem

It is due to arrested political development that Indonesia's reforms do not seem credible. Active political figures carry baggage from the past; promising, capable young leaders are not available. Suharto's hand-chosen successor, Habibie, having grown up in the Suharto household, is virtually a son. Twenty of 36 ministers of the reform cabinet served in Suharto's last administration; many represent the same political interests that have blocked reform in the past, and they have the most to lose from any future liberalization or tighter supervision of the banks. The major political party is still controlled by the Suharto clan. Even the food distribution system is in the hands of a crony who could control whether people eat or starve. With few options for multilaterals to depend on other than the existing power structure, the promised reforms lack credibility. Investors, shunning an Indonesia run by the same individuals who have blocked change in the past, are returning to Thailand and South Korea, where elected governments with new faces are committed to reform. Political failure is why Indonesia's problems surpass those of its neighbors.

Myth Four: Prosperity Can Be Restored Without Major Political Reform

The collapse of Indonesia's economy offers the donor community a clear example of how development assistance can postpone necessary domestic institutional and political reform. But history offers many useful lessons from analogous situations that can lend perspective to events in Indonesia.

Consider a financial crisis that occurred in 1787 in highly centralized, autocratic Old Regime France. With the crown's finances shrouded in secrecy, a credit default spiral unfolded upon a rumor that a private financier was bankrupt. Although the economy seemed healthy, government finances collapsed. In fact, the French kingdom's credit structure is highly analogous to that of Indonesia today in several ways. The crown's financial intermediaries used their own reputations to borrow short-term overseas, lending to the crown at higher interest rates. With currency stability guaranteed by the sovereign, France became a haven for Europe's savings. But when doubts emerged about the solvency of the system, there was no IMF to step in and provide breathing room. To avoid bankruptcy, the crown had to convoke an assembly of national representatives who demanded political reforms in exchange for higher taxes. The political sources of the French financial crisis were resolved through an extensive institutional overhaul that improved the accountability of government to citizens. France's complete political transformation included modern property rights and a public debt, helping transform a pre-industrial, impoverished nation of peasants and lords into a major industrial power.

When the English monarchy ran out of funds twice during the 17th century, it had yet to make political concessions to an elected body that gained control over the purse strings of government. The parliament demanded an annual budget from the king that anticipated all receipts and expenditures so that it could predict and control spending. A funded public debt resulted, with the parliament holding much of that debt. As in France, a political settlement allowed the nation to exit a financial crisis with enhanced financial capacity. By contrast, with the IMF stepping in, Indonesia has no motivation to design institutions that bind the interests of its elite to the welfare of the state. Instead, Indonesia's citizens are taxed by an international body they do not elect.

"...with the IMF stepping in, Indonesia has no motivation to design institutions that bind the interests of its elite to the welfare of the state."

As a result, Indonesia's end is more likely to resemble that of two other cold war relics. Strategic allies of the West during the cold war, Pakistan and the Philippines have the most reactionary social structures in their respective regions and the highest levels of debt to multilateral lenders. These nations today have elected governments with representative bodies that are not accountable for the nation's fiscal performance. Just a few families, which rarely pay taxes, continue to dominate the economy; extreme inequality flourishes and endemic corruption eliminates long-term investment strategies.

However, Ayub Khan's Pakistan was the donor showcase of the 1960s, and the Philippines of Marcos was the flagship borrower of the 1970s; both featured high growth through donor-assisted borrowing. Both regimes were celebrated for being technocratic autocracies, yet their economies were and continue to be controlled by oligarchs who prosper by plundering governmental resources—much of which is borrowed in the name of the sovereign—while contributing little capital of their own to their nations' industrial foundations. Loans to private individuals for pet projects that made little economic sense were available through political access. Rich foreign friends bankrolling a compliant elite made permanent beggars of both countries. The ability to roll over existing debts has helped them avoid reforming the system toward public accountability. The resulting massive debt overhang has reduced the development prospects of both nations, making it essentially impossible for their economies to recover.

Will Indonesia join a cohort of nations that have become perpetual international beggars, rather than link its citizens' private interests to collective responsibility for the nation's finances? The IMF bailouts imply that the nation must bear the burden of debt to pay for the loot of its leaders. Indonesia's situation could become the greatest case of debt overhang in history, as it may require refunding the entire banking system to pay for the poor investment decisions of its leaders. Unable, then and now, to subject its leaders to accountability for effective governance, a country that might have been a giant is destined to become permanently crippled, able to provide prosperity to only a small segment of its population. Is this the future Indonesia's friends have in mind?

HILTON L. ROOT *is a senior fellow at the Milken Institute.*