After Soeharto: Prospects for reform and recovery in Indonesia

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Abstract

With Soeharto's demise, Indonesia gained democracy but lost effective government. The economy has been slow to recover from the crisis, and even modest growth of around 3–4% may not be able to be maintained: neither stagnation nor decline is out of the question. It is therefore urgent to overhaul Indonesia's public sector institutions, which had been co-opted by Soeharto into his economy-wide 'franchise'—a system of government devoted to the objective of redistributing income and wealth from the weak to the strong while simultaneously maintaining rapid growth. This franchise has disintegrated in the absence of a clear 'owner', with its various component parts now working at cross purposes rather than in mutually reinforcing fashion. The result has been a significant decline in the security of property rights and the postponement of a convincing economic rebound. To reform the public sector institutions it will be necessary to undertake a radical overhaul of personnel management practices and salary structures, with the objective of providing strong incentives for officials to work in the public interest. The prospects for such reform, however, seem slight.

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INTRODUCTION

Indonesia's long-serving president, Soeharto, became more unpopular the longer he remained in office. The economic crisis that began in mid 1997 provided the conditions under which at last he was able to be forced out, only a couple of months after he had been elected unopposed to a seventh five-year term. Since then the country has been able to manage a relatively peaceful transition to a more genuine democracy. The first stage of this began with the formal handover of power by Soeharto to his deputy, BJ Habibie, in May 1998. The second involved the holding of elections for the parliament in June 1999, and the subsequent indirect election of Abdurrahman Wahid by the People's Consultative Assembly (MPR) as the first president of the new democratic era. The third saw the dismissal of Wahid in July 2001, and his replacement by Megawati Soekarnoputri, also by the MPR.

Macroeconomic conditions have stabilised after the astonishing upheaval in 1997–98. The exchange rate stabilised many months ago, and recently has been appreciating. Inflation, although still rather high relative to Indonesia's neighbours, is back to levels that had become the norm prior to the crisis, and interest rates have also declined to roughly pre-crisis levels. But short-term forecasts are for growth at the rate of just 3–4 percent per annum—half the average growth rate maintained over three decades of Soeharto's rule.

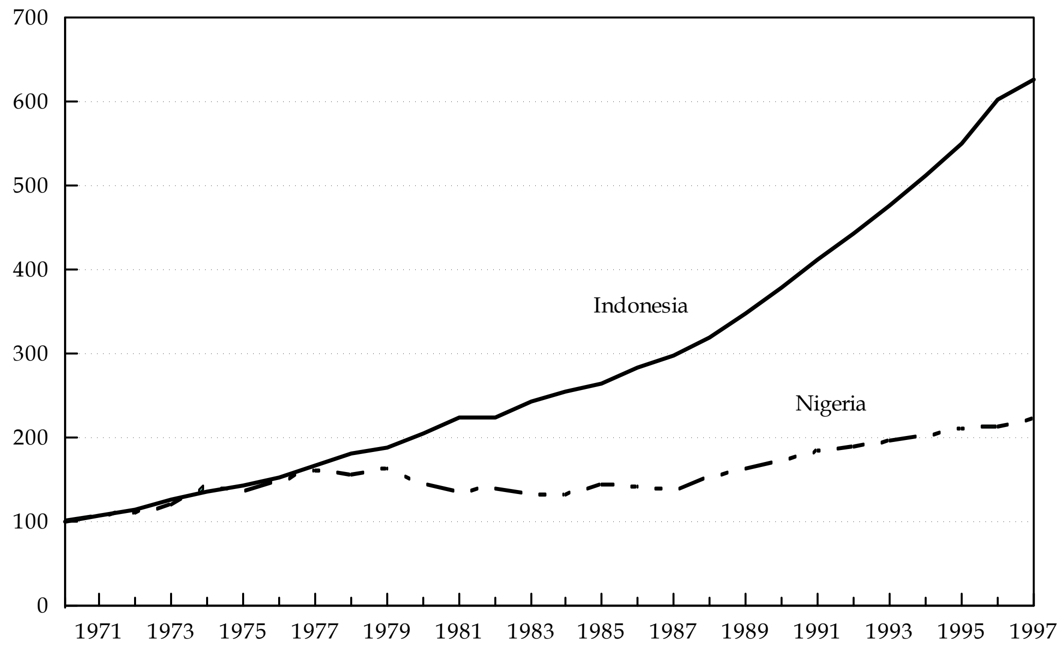
More important, there are serious doubts as to whether even this modest rate—which is inadequate if poverty is to be reduced appreciably—can be maintained into the future. One very worrying economic indicator is the level of investment, which languishes at just three-quarters of its level prior to the crisis. Growth is possible without new investment given that there is still unutilised production capacity during recovery from recession, but as existing capacity becomes more fully utilised, the scope for further growth becomes increasingly limited. The failure of business investment to recover can only be interpreted as a sign of a continuing lack of confidence that Indonesia's new democracy will give rise to an effective government capable of doing the things needed to allow the private sector to function properly.

Is 'muddling through' the best that can be expected? Is it the worst?

It is common in Indonesia these days for people to talk about 'muddling through' (e.g. *Business News* 10 February 2003). Few seem to think it possible to get back to 7–8% growth, but at the same time, few seem to think that growth might fall back to zero or even turn negative again. These more pessimistic possibilities should be taken more seriously. After all, ineffective government under Indonesia's first president, Sukarno, resulted first in stagnation and then negative growth during the last several years of his rule, contributing to political instability, a violent change of regime, and an effective takeover of government by the army.

But perhaps even this does not reflect the limit of how bad things could become. Consider the case of Nigeria, a country whose per capita income was somewhat higher than Indonesia's in the late 1960s. It also has a large population and large oil resources, making it an interesting and relevant comparator. The growth performance of these two countries was very similar up until the late 1970s, when Nigeria's real GNP stagnated and then began to decline from the beginning of the 1980s; modest positive growth did not reappear until late in the decade (Figure 1). Although Indonesia's growth faltered slightly in the early 1980s with the decline in world oil prices, it was able to recover very quickly thanks to sound management by its macroeconomic policy makers. Nigeria's real GDP in 1996 was only 2.2 times its level at the end of the 1960s, whereas Indonesia's was 6.3 times its level at that time.

Figure 1 Real GNP Growth: Indonesia and Nigeria
1970=100



Source: World Bank World Tables

It is important, therefore, not to underestimate the possible consequences of ineffective government. Indonesians have already been reminded how quickly the quality of government can decline under incompetent leadership and a weak bureaucracy. Fortunately, the erratic Abdurrahman Wahid was able to be removed before he was able to do much damage (Siregar 2001: 278–9), but doing so relied on the availability of a replacement who commanded considerable popular support,[1] and who was able to put together a reasonably competent cabinet. The people may not be so fortunate in the future, should they happen to choose poorly in a presidential election.

With these comments as background, the aims of this paper are:

- to explain why Soeharto's regime was effective, and why subsequent governments have been much less effective
- to suggest the reforms needed if effectiveness is to be regained (and to discuss other kinds of reform initiatives)
- and to comment briefly on the prospects for a return to rapid economic growth.

I shall argue here that with Soeharto's demise, Indonesia gained democracy but lost effective government. By gaining democracy I mean that the people now have the genuine opportunity to vote out incumbent governments at regular intervals, and I interpret effective government in a purely economic sense to mean doing what is needed to achieve rapid growth—with the expectation that the benefits of growth will be widely spread amongst the population, as was the case during the Soeharto era. Specifically, I assume that rapid economic growth depends on a complementary relationship between the private and public sectors, in which the public sector provides things desired by the public but which the private sector is not able to produce.

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[1] Megawati's party had won almost three times as many votes than Wahid's in the 1999 election.

I argue that by far the most important task of the public sector is to ensure the rule of law and the security of property.[2] In turn, this requires the drafting and enactment of laws and provision of the means to enforce them: a judiciary, a legal bureaucracy (including a public prosecutor), and a police force. The weaker is the rule of law and the security of property, the weaker is the incentive to invest and to work.[3] Since growth or development depends on investment and the supply of effort by individuals, economic performance of an economy overall can be expected to be, and is, strongly correlated with the security of property (Roll and Talbott 2002: 15–16).

The provision of physical infrastructure by the public sector is also important: roads, ports, airports, storm-water drainage and flood control, sewerage and so on. Beyond this, there is room for debate as to what other things governments should provide, but this is outside the scope of the present discussion. The principal focus here is on the crucially important provision of the rule of law.

THE FUNDAMENTAL DETERMINANTS OF PERFORMANCE

It is a truism that the overall performance of any organisation or regime depends on the performance of the individuals that comprise it, other things equal. In turn, individuals' performance depends on the strength of the incentives they face, both positive and negative. I shall argue that the incentives for good performance in the public sector institutions during the Soeharto era were strong—*relative to Soeharto's objectives*, which happened to coincide largely with society's objectives. By contrast, the incentives for good performance in those institutions subsequently have become weak—*relative to society's objectives*. The decline in Indonesia's economic performance since Soeharto's demise can be explained by this change in the structure of incentives facing officials in the public sector institutions.

[2] Interestingly, a similar argument has recently been put in relation to priorities that need to be followed in establishing a new democratic regime in post-war Iraq (McDougall 2003).

[3] 'Why does an individual invest unless to gain something for himself and his family? How can he ensure that gains flowing from his activity be appropriated and secured other than through a system of well-defined property rights?' (O'Driscoll and Hoskins 2003: 9).

Soeharto's franchise system of government

Soeharto created incentives for effective government within what I have described elsewhere as a 'franchise' system (McLeod 2000). A more descriptive, if cumbersome, title would be 'multi-branch, multi-level franchise'.[4] The branches of the franchise included: the legislature (MPR, DPR[5] and tame political parties); the judiciary and the legal bureaucracy; the military/police; the bureaucracy (including non-department agencies, especially the logistics agency, Bulog, and the central bank, Bank Indonesia); and the state-owned enterprises (SOEs), including banks. Most of the branches encompassed a number of levels. Legislatures existed at national, provincial and district/municipality levels, while the bureaucracy extended right down to the villages. The hierarchy of the judiciary extended down from the Supreme Court through the High Court to the district courts. The army also had regional divisions, as did the state banks.

The franchise analogy is useful because of a number of important characteristics the Soeharto regime shared in common with franchises in the world of commerce, such as McDonalds and Starbucks. Such franchises are based on a mutually advantageous contractual relationship between the franchisor and multiple franchisees; the franchisees pay to join and to continue as members; the franchisor designs the product line and sets the overall operating parameters; and other aspects of management are delegated to the franchisees. In the case of Soeharto's franchise, the 'product' was the *right to engage in 'private taxation'*—that is, various forms of taxation imposed by public sector officials (franchisees) for their personal benefit.

Private taxation

As with all franchises, success depended crucially on product design, so the key here was the nature of this private tax system. The most effective taxation regimes rely heavily on *low rates of tax* imposed on a *large tax base*. High tax rates tend to kill off the economic activity to which they are applied, and therefore fail to maximise tax

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[4] Liddle (1985: 71) refers to the political structure of the New Order as 'a steeply-ascending pyramid in which the heights are thoroughly dominated by a single office, the presidency'. Crouch (1991: 57) refers simply to 'Soeharto's patronage network'. My justification for using the 'franchise' analogy is discussed below.

[5] The MPR is the Peoples' Consultative Assembly; the DPR is the House of Representatives.

revenue. Soeharto appears to have been highly unusual among corrupt autocrats and dictators in his understanding and application of this principle, and it is this that explains the fact that such rapid economic growth could be sustained over three decades, despite Indonesia coming to have a reputation as one of the most corrupt nations in the world.

There are numerous ways in which public sector officials can impose private taxation, but two broad classes are of particular importance. The first is extortion. Some obvious examples are when people and firms are forced to pay officials if they want to be issued with, or to retain, licences required to undertake particular activities, or if they want to induce the officials actually to provide services to which the people and firms in question are already entitled, including protection by the police against violence and intimidation. The second is rent generation and harvesting. An example of this is public sector direction of the exploitation of natural resources for the benefit of the few at the cost of the many, such as the award of timber concessions to favoured individuals or companies. Another is where an official provides a firm with a legal monopoly, and the firm shares the rents generated by the monopoly with the official. A third is where the state, or a state-owned enterprise, engages in a commercial transaction with a private sector entity on terms very much more advantageous to the latter than those prevailing in the market. In both cases, the public sector official—who may be the president, at one extreme, or a petty official at the lowest level of local government, at the other—gains. In the first case the counterparty loses; in the second the counterparty also gains, at the expense of the general public.[6]

The mix of these two kinds of private taxation is important. Extortion is a violation of property rights, and is clearly a drag on economic performance for that reason: if it becomes excessive it will drive the taxed economic activity out of existence. Natural resource exploitation (in the absence of reasonable royalty payments to the government) amounts to wealth redistribution away from the general public in favour of those granted rights to exploitation and the public sector officials with

[6] These two forms of private taxation can be interpreted to reflect the 'KK' in KKN—Indonesia's popular acronym for corruption, collusion and nepotism, if we take corruption to mean illegal levies imposed by officials, and collusion to mean mutually advantageous arrangements between officials and crony companies, respectively. Nepotism is simply a particular form of collusion.

whom the rents are shared. It avoids the disadvantage of hindering other economic activity, however, since the general public presumably has only the vaguest perception that it shares in the ownership of these resources as a constitutional right,[7] and therefore has little sense of direct loss.

Rent creation and harvesting, on the other hand, has been suggested by some actually to promote economic progress. The implicit argument is that if firms can be given protection from competition this will enable them to earn high profits that can then be reinvested, thus generating further growth. Whether this is true is an empirical issue; presumably the answer depends in part on how severely the process of resource allocation is distorted in order to generate rents.[8] If the distortions are relatively mild, the resulting implicit taxes on other activities and entities will be small, and there may be little or no noticeable impact on economic growth overall. This seems to have been the case during most of the New Order period, although it may be argued that the unbridled greed of the Soeharto children and grandchildren resulted in increasingly large distortions during the last several years before the crisis.[9]

One important difference between the first kind of private taxation and the second is that the former puts wealth in the pockets of public sector officials that may lack entrepreneurial capability, whereas the latter, by definition, shifts wealth in favour of people who do. To put it in simple terms, in one case ill-gotten gains end up being reinvested in the economy, while in the other they end up in Swiss bank accounts (Salim 1997: 69), or being frittered away on consumption. These less desirable outcomes can be avoided if officials that end up controlling economic resources

[7] Article 33, paragraph 3 of the constitution states that 'The land, the waters and the natural riches contained therein shall be controlled by the State and exploited to the greatest benefit of the people.'

[8] This raises the interesting question of which forms of rent generation deliver the largest rent harvest to crony companies for a given cost to the rest of the economy. For example, privileges for exporters may be less damaging than those for producers of import substitutes, while those for producers of non-tradables may be less damaging still. If so, this would help to explain why the pattern of privileges arguably has tended to shift from import substitution to exports to non-tradables over time in Indonesia. Such questions are beyond the scope of this paper.

[9] Some well known examples include the monopolization of domestic trade in cloves, the attempt to privately tax the sale of beer in Bali, the attempt to monopolize sales of shoes to schoolchildren (McLeod 2000), and the introduction of the national car project (Manning and Jayasuriya 1996: 18–21).

(such as forestry concessions), perhaps upon their retirement from the armed forces, sub-contract the work of exploiting those resources to more entrepreneurially talented individuals; in Indonesia these are known as '*cukong*' relationships (Liddle 1985: 78; Elson 2001: 151–2). In essence this is simply another form of rent-generation and harvesting. The large-scale domestic reinvestment of rents is both a reflection of, and an explanation for, the regime's success in sustaining a high rate of economic growth over three decades.

Soeharto as franchise owner

In a business franchise, there is no question of the owner being forced out (although, of course, if it is unsuccessful the franchisees will desert it). But Soeharto's franchise was a political system from which, in principle, he could be removed through the election process. To avoid this possibility, as is well-known, the election system was rigged so that he could not be voted out of office (Liddle 1985: 71–2; Elson 2001: 186–90). At the same time, he dealt with actual or potential threats from within by buying off the individuals in question with appointments to senior positions within the bureaucracy, the judiciary and SOEs, or by granting privileged access to timber concessions and so on. Those who could not be neutralised in this manner could expect to be harshly dealt with. Public sector officials who incurred the displeasure of Soeharto or his franchisees would find their career advancement blocked in one way or another, while others found themselves being imprisoned (Crouch 1991: 56; Cole and Slade 1998: 65; Lindsey 2001: 56–7).

Franchisees' benefits, obligations and incentives

Franchisees in each of the branches enjoyed the opportunity to collect or share in private tax revenues, and could hope for promotion to higher levels of the franchise—with commensurately higher rewards—over time. They also enjoyed ready opportunities to engage in nepotism, and could expect support from higher levels, and from other branches, of the franchise. In return for all this, they were required to pay (in cash or kind) to join, and for continuing membership.[10] They

[10] An infamous example is the case of a *bupati* (regent) in Yogyakarta province, who was alleged to have paid the equivalent of about US$425,000 in order to secure his reappointment. The journalist who reported the allegations had also reported on irregularities in the management of the regency's poverty alleviation program funds, and was subsequently murdered by a group of thugs (*Jakarta Post* 17 September and 16 October 1996).

were expected to assist with the recruitment of lower-level franchisees and with the promotion of the better performers. They also had to shift poor performers out of the way of others who could do better, and to deal with threats to the franchise.[11]

In terms of incentives, franchisees had the opportunity to become very wealthy if they served the interests of the franchise well. On the other hand, there was the threat of exclusion, or worse, if they failed to do so, or if their actions threatened the well-being of the franchise.[12] In short, Soeharto's franchise system had at its core a strong system of carrots and sticks designed to elicit good performance from its franchisees.

Roles of the branches

Each public sector institution was intended to serve the interests of the general public, but in cases where there was any conflict, the interests of the franchise generally took precedence. The main specific roles of each branch in serving the franchise included the following:

The *legislature* allowed the regime to present a facade of democracy to the world and to the Indonesian public, which helped it to tap into a significant inflow of resources from multilateral and bilateral donors. Its main functions were to rubber-stamp legislation submitted by the government; to absorb and deflect public criticism of the government's performance; and to provide attractive positions into which people could be shifted from elsewhere in the franchise.

The *judiciary and legal bureaucracy* were expected to deflect legal challenges to the regime and the actions of franchisees;[13] to impose legal sanctions on opponents of

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[11] Liddle (1985: 76) discusses how the regime dealt with opposition from students and politically organized Islam, for example.

[12] A fascinating example of the lengths to which Soeharto would go in dealing with lack of discipline within the franchise was his replacement of the customs service in 1984 with the private company Societe Generale de Surveillance (Muir 1986: 21). The customs inspection process had come to impose such heavy private taxation on international trade as to significantly constrain economic growth.

[13] A rare exception was the upholding by the Supreme Court of a previous court decision in favour of villagers who had been displaced without adequate compensation by the government's Kedung Ombo dam project. But this decision was subsequently overridden by the Supreme Court itself after the government appealed, demonstrating clearly the 'proper place' of the judiciary within the franchise system (Chatterjee 1995; Association for International Water and Forest Studies, no date).

the regime; to protect and further the interests of privileged firms and individuals within the private sector; and, like the legislature, to provide attractive positions into which people could be shifted from elsewhere in the franchise.

The *military/police* provided the coercive force by which the regime was protected against challenges (for example, from students, Moslems, secessionists, and NGOs). Other major functions included helping to ensure election victories for the government party, Golkar (Crouch 1991: 54), and '[ferreting] out dissent within the government' (Liddle 1985: 76). Finally, it helped to suppress militant labour, which might otherwise have hindered firms' growth and the creation of employment opportunities, especially in manufacturing.[14]

The *bureaucracy* was responsible for devising and implementing economic policies conducive to rapid economic growth, by virtue of which the size of the tax base for private taxation could be steadily increased. It also implemented a wide range of policies whose purpose was to generate rents for privileged companies and individuals; in turn, these rents were shared with the franchise through various mechanisms (McLeod 2000). At the same time, it implemented a number of other policies that were intended to generate public support for the regime—or at least to soften criticism of it—such as increasing the public's access to education and health services,[15] and providing various kinds of subsidies for farmers and small businesses.[16]

The primary role of the *state-owned enterprises* was to generate rents for privileged private sector companies by way of distorted pricing in its transactions with them. Purchases were made at excessively high prices, sales at excessively low prices, and

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[14] A sickening example of this involved the 'abduction, rape and murder in May of a 23 year old female worker, Marsinah, who had helped organise a strike at a watch factory in Surabaya' (Fane 1994: 38). The case has never been resolved satisfactorily (Amnesty International, no date).

[15] Primary and secondary school enrolments as a percentage of the respective school age populations grew dramatically during the Soeharto era, and there were enormous improvements in health indicators such as life expectancy and infant mortality. As Liddle points out, however, the beneficiaries of such spending by the government also included '[b]uilders, cement manufacturers, textbook printers, and the bureaucrats who award the contracts…' (Liddle 1985: 80).

[16] Two of the best known programs were the Bimas 'mass guidance' scheme for small farmers (Subroto 1998: 79), and the KIK/KMKP loans for small business program (Bolnick 1982).

loans or credit were provided at below market rates—often with the added benefit of optional default (Fane 1994: 31).[17] In addition the SOEs also served to provide attractive positions for individuals being transferred from elsewhere in the franchise.

The regime provided effective government

In summary, the franchise was designed to provide franchisees with strong incentives to work for its success.[18] It prospered by drawing lightly on a 'tax base' that comprised a large part of the economy as a whole, and by implementing economic policies that helped the private sector to generate rapid economic growth in order that the tax base would also grow rapidly. Thus there was a close correspondence between the interests of the franchise and the interests of the general public, notwithstanding the fact that the effect of private taxation was to redistribute income and wealth from the weak to the strong. Despite the legendary corruption and incompetence of the legal system and the bureaucracy, the rules of the game enforced by the franchisor were such that property rights were relatively secure for the majority of the population.[19]

To my knowledge, no student of Indonesia came close to predicting how the regime would end, nor what would happen subsequently. For example Liddle (1985: 86) wondered about 'the possibility that the New Order pyramid [would] be destroyed as a result of a succession struggle'. He argued that this outcome was unlikely because of 'the special position of the military in the pyramid' and the extent to which younger officers had been incorporated into the *cukong* system. Even if Soeharto were overthrown, however, he expected this system to remain, 'alongside

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[17] Aside from the state banks, the state oil company, Pertamina, probably played the preeminent role of this kind amongst all the SOEs (*Laksamana.Net* June 30, 2002).

[18] Liddle (1985: 74) refers similarly to 'the building of performance-based support within the pyramid'.

[19] Liddle (1985: 78) argues that periodic crackdowns on corruption '[encouraged] the public to believe that the government [was] at least well intentioned'. No doubt there is something in this, but I would argue also that Soeharto appreciated that excessive infringement of property rights by individual franchisees was inimical to the interests of the franchise as a whole. The replacement of the notoriously corrupt customs service by a private company in 1985 (Elson 2001: 247), and the 'mysterious shootings' of thousands of criminals and extortionists in the early and mid-1980s (ibid: 236–8) can readily be interpreted in this light.

something very like the present New Order pyramid' (*ibid*: 87). Similarly, Crouch (1991: 65) talked in terms of a smooth transition from Soeharto to his successor, with his 'powers and authority more or less intact', but perceived an equal possibility that 'in the absence of a generally accepted heir, the new president [would] only take power after an intense struggle within the military elite'. So far as democracy was concerned, however, he argued that 'the urban middle class and the business class … [were] not yet strong enough to impose their will on the government and force increased popular representation' (*ibid*: 63). In the end it was indeed the middle class and the business community—including foreigners—that imposed their will on the government, not with their votes but by sending their capital offshore and precipitating the economic crisis that led ultimately to the breakthrough of democracy.

The franchise has in fact disintegrated with the passing of Soeharto. None of his successors has been able to exert much control over its several branches, which are now working at cross purposes, resulting in high levels of private taxation in some areas of the economy. Property rights have therefore become much less secure for both firms and individuals (see, for example, *Jakarta Post* 10 May, 2003). The failure of investment spending to recover in these circumstances is not surprising.

THE DEMISE OF THE FRANCHISE

The system started to fall apart as the current crisis got under way in mid 1997 and Soeharto began to lose control. Most obviously, several of the business conglomerates, previously content to prosper on the basis of policies that considerably reduced their need to compete with other firms, now perceived that the days of the franchise were numbered. There was a strong possibility that there might be no opportunities at all beyond the next few months to harvest any more rents. Moreover, by this time they were quite capable of investing and operating offshore, such as in the rapidly opening Chinese economy. There was therefore both a strong incentive and plenty of scope for them to take what they could, while they could, resulting in a radical shift in behaviour that amounted to looting the national treasury.

The great bank robbery

The primary mechanism by which they did so was by defaulting on the loans that they had received from the state banks and their own banks—in some cases, increasing the volume of such loans considerably first, using funds supplied by the central bank (McLeod forthcoming). The effect of walking away from their debts was significantly to enrich themselves at the expense of the general public, by virtue of the fact that the government took it upon itself to guarantee all of the liabilities of the banking system.[20] This resulted in an extraordinarily large redistribution of wealth within Indonesian society, which has been estimated to exceed 40% of GDP in value (Fane and McLeod 2002: 288). The wealthy individuals in question could not have succeeded in this endeavour were it not for a mixture of incompetence and corruption within the bureaucracy and the judiciary, together with political pressure applied to these branches of the franchise by Soeharto himself, and later by his successors.[21]

The most egregious shortcoming on the part of the policy makers was to enter into fatally flawed Master Shareholder Settlement Agreements (MSSAs) with the owners of the conglomerates whose banks failed.[22] The key word here is 'Settlement': literally, the government allowed the conglomerates to settle—that is, *fully to discharge*—their obligation to it by transferring ownership of portfolios of assets (business enterprises, for the most part) supposedly with a value at least equal to those obligations. By so doing, it incurred the risk that the actual value of these portfolios would be less than first thought, in which case it would not be in a position to insist that the conglomerate owners hand over additional assets, even if it was quite obvious that these were available in abundance. To make matters worse, the government was unable to find enough qualified business managers to take control of these newly acquired enterprises, leaving them effectively under the

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[20] Some conglomerate owners may have lost significant amounts by virtue of their previous exposure to exchange rate risk, but this is a separate issue.

[21] The single biggest debtor to the Indonesian bank Restructuring Agency is the Texmaco group. Texmaco defaulted on well over $1 billion in loans from the state banks, which had been made on the instructions of Soeharto (Fane 2000: 29–30; *AsiaWeek.com* 24 December 1999). The group was later protected against any attempt to seize management control of its assets by then president Wahid (*Deutsche Bank Indonesia Newsletter*, May 2000). There has been no change in this policy under the Megawati government and, rather predictably, the firm has recently defaulted on even its generously rescheduled borrowing obligations (*Laksamana.Net* 15 April 2003).

[22] The government's prior decision to guarantee the banks' liabilities was the first step along this road to ruin. An alternative approach to keeping the banks operational through the crisis at no cost to the government is set out in McLeod (2003).

control of their original owners and therefore 'ripe for picking'. It should come as no surprise that the revenues from disposal of these assets will not come close to covering the government's outlays on the bank bailout, nor that the conglomerates involved have gone from strength to strength.

Foreign investors in the firing line

In the early months of the crisis the conglomerates as a group gave priority to maintaining good relationships with their foreign creditors, not only continuing to service their borrowings but also repaying principal amounts in advance in order to avoid further losses if the rupiah continued to depreciate. Their ability to do so was increased by the willingness of the state banks to lend to them, the central bank's willingness to lend to their banks, and the government's willingness to guarantee those banks' liabilities. This strategy of treating government institutions and the government itself as soft targets relied on the corrupt nature of the judiciary, which ensured that when the government came to press its claims against the conglomerates it would have virtually no chance of success. Such has been the success of this strategy, however, that several conglomerates have more recently shifted their attention to their foreign creditors—recognising that they, too, would be no match for them in Indonesia's corrupt court system.[23]

Two cases stand out. The first is that of Asia Pulp and Paper, which had continued to expand aggressively during the Asian crisis. Already heavily in debt, it succeeded in raising a further $404 million in April 1999 (*Dow Jones International News* 23 April, 1999), and $123 million in September 2000 (*Bisnis Indonesia* 12 September, 2000). The group began to default on what was eventually revealed to be some $13.9 billion of foreign borrowings in March 2001, but has managed to avoid the takeover of its assets by its creditors thus far (*Wall Street Journal*, 2 April 2003). Complicating the issue is the fact that the company had borrowed heavily from Bank Internasional Indonesia, which was part of the same conglomerate (Sinar Mas, owned by the Wijaya family). This bank was one of those taken over by the Indonesian government when the banking system collapsed, and when APP defaulted on its

[23] For example, the US Foreign Corrupt Practices Act makes it virtually impossible for US investment funds to pay the bribes that are essential, in reality, to obtain a favorable court decision (even with a seemingly watertight legal case), or to have court decisions enforced.

debts these loans were shifted to IBRA, making it the group's biggest single creditor. It appears to have been exploiting this dominant position to get the best deal it can, with little regard for the interests of the foreign creditors involved. Given the huge amount of money involved, it is no surprise that this has damaged Indonesia's international standing to such an extent that the ambassadors of some 11 nations have written directly to the president seeking her intervention (*Bloomberg* 28 April, 2003).

The second is that of Tri Polyta Indonesia (TPI), which has sought to have the courts invalidate $185 million worth of bonds it issued before the crisis began. It recently succeeded in having a provincial court block the seizure of its assets by foreign bondholders after it began to default on payments in 1999. To add insult to injury, TPI is also suing bondholders for the return of interest previously paid, and for 'emotional distress caused to the company management' (*Bloomberg*, 9 April 2003). If the court finds in favour of TPI, the bondholders' $185 million asset will have been transformed into a liability of more than $600 million (the total amount now claimed)! It would be hard to imagine a more egregious example of the growing insecurity of property rights.

Another important aspect of this shift in behaviour is that it has been accompanied by a redeployment of assets of the conglomerates. Whereas previously they collected rents and to a large extent reinvested them domestically, a large proportion of their wealth has now been relocated to countries such as China, Singapore, the US and Australia. This shifting of wealth offshore was, of course, the proximate cause of the large real depreciation of the rupiah.

A watershed in Indonesia's modern history

The important question raised by the change in behaviour of large-scale business is whether it was just the first signal of a breakdown in the coherence of the franchise, to be followed by similar examples of opportunistic behaviour. Would this be the moment when Soeharto's franchisees would start thinking in terms of killing the goose, rather than contenting themselves with collecting the supply of golden eggs?

There is a good deal of evidence to suggest that a breakdown of the franchise is exactly what has happened since the fall of Soeharto.[24] It is this evidence that makes the forlorn example of Nigeria relevant to questions about what Indonesia's future may hold. In the past, a major factor that differentiated Indonesia from countries like Nigeria was Soeharto's 'better class of corruption' (McLeod 2000: 157). As we have seen, the level of private taxation was kept to a level that was low enough not to remove the incentive to undertake economic activity. At the same time, firms that harvested rents generated by the franchise could only do so by investing and re-investing in the Indonesian economy. But in the absence of strong leadership able to enforce discipline over franchisees, the franchise has now collapsed. Its various branches and sub-branches are increasingly going their own way, with the result that the level of actual and anticipated private taxation is becoming oppressive in some areas of the economy.

The problem is clearly manifested in the shifting of capital offshore, and the continued reluctance of the private sector to undertake new investment. Domestic and foreign firms that previously harvested rents generated by the franchise can no longer be confident of their ability to do so in an environment in which the leadership of government is genuinely subject to change at regular intervals, and they therefore have much weaker incentives to invest in Indonesia. Firms that previously put up with extortion, since it remained relatively light, now find it more threatening in the absence of centralised control. Banks that would like to be lending more are afraid to do so because they cannot rely on the courts to enforce their loan contracts.

Paradoxically, the flowering of democracy itself is also imposing additional costs on the corporate sector. Soeharto had relatively little need to 'tax' corporations to fund Golkar's election campaigns, because the whole election process was a charade in which Golkar could not lose. But now there are several parties with enough electoral support to be considered serious contenders to become members of governing coalitions, and each of them has large campaign funding requirements. No doubt many companies are making contributions to some or all of these parties in order to

[24] One important aspect is the push by some provinces to break away from the Indonesian state. East Timor has already succeeded; secessionists in Aceh and Papua are actively pursuing their aims. Discussion of this issue is beyond the scope of this paper.

try to secure their fortunes through the next phase of the electoral cycle, as the infamous Bank Bali corruption case suggests (Fane 2000: 42). State enterprises are being privately taxed by the political parties for the same purpose. Unfortunately, using private tax revenues to fund election campaigns is akin to using them for consumption, rather than for reinvestment in productive activity, so far as their economic impact is concerned.

There are many examples of changing behaviour on the part of the branches of the former franchise itself (as distinct from its outside beneficiaries and the political parties) that show that they have lost their coherence, and thus have become an obstacle to economic recovery, with the fall of Soeharto. This gives strong reason to doubt that Indonesia will be able to re-establish effective government in the near future. In addition to increasing the net rate of private tax imposed on firms and individuals, and increasing the degree of uncertainty about property rights and the future course of development, the effects of the collapse of the franchise are to increase the rate of exploitation of natural resources and to constrain the ability of more conscientious members of the government and the bureaucracy to implement sound economic policies. Consider the following examples.

A judiciary out of control

The judiciary has become much more prominent in the wake of the crisis, primarily because so many firms and banks have become insolvent—or have merely stopped servicing their debts. Large scale bankruptcy had rarely been an issue in the pre-crisis era, but now many creditors suddenly began to file bankruptcy claims against defaulting debtors, and the judiciary found itself in a position in which it had far greater opportunities than before to benefit financially from the larger and more numerous cases coming before it. The biggest creditor of all was IBRA, the Indonesian Bank Restructuring Agency, a new part of the bureaucracy. IBRA was established in 1998 and given the task of recovering as much as possible of the government's outlays on the bank bailout, and thus protecting the interests of the general public. But it found itself in an unequal contest of strength with the judiciary, which has been only too willing to exploit its position in order to extract large bribes from the defaulters—at IBRA's expense. This, in turn, has created enormous pressure on the budget, and weakened the government's ability to undertake the expenditures necessary in order to keep the economy in good shape (Pangestu and Goeltom 2001: 144).

Another party to suffer has been the foreign investment community, which used to rely heavily on the 'franchise connection' for the protection of its assets and activities in Indonesia (Cole and Slade 1998: 65),[25] but has found the going very tough in Indonesia's corrupt court system since Soeharto's demise. One well-known example is the Canadian company, Manulife, which bought out the shares of its local joint venture partner, the Dharmala Group (Dick 2001: 30); the latter had had to surrender these shares to IBRA by virtue of the failure of its bank. After this deal had been completed, the Dharmala Group brought a case against Manulife, complaining that the shares in question were counterfeit (*Australian Financial Review*, 24 November 2000). Much later, having failed to make this charge stick, Dharmala was able to persuade the court to declare the local subsidiary, Manulife Indonesia, bankrupt, although it clearly was not (*Jakarta Post*, June 14 2002). Eventually this decision was overturned, but only after considerable pressure was brought to bear—amongst others, by the Canadian government (*Laksamana.Net*, 22 January 2003).

There have been other broadly similar cases in which foreign firms and investors have been very badly treated by the courts. The absurdity of the claim against bondholders of TPI, mentioned above, is an indication of how dysfunctional the judiciary has become: instead of protecting property rights it is now being used as an instrument of expropriation. In cases such as these, this unholy alliance between the judiciary and domestic capital conflicts with the efforts of Indonesia's economic policymakers to persuade foreign capital to return, and thus to assist with economic recovery.

An extortive legislature

The legislature never stood in the way of successive Soeharto governments, the bulk of its members being able to be kept acquiescent by a relatively modest flow of patronage (Sherlock 2003: 4), mainly through the bureaucracy and Soeharto's electoral machine, Golkar, which always accounted for a large majority of seats in parliament. Others who took their responsibilities more seriously felt powerless to oppose the regime. Since the fall of Soeharto the balance of power between the legislature and the executive has changed dramatically (*ibid*: 19–21). The people's

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[25] Virtually all large scale foreign investors had felt obliged to have Soeharto family members or cronies as joint venture partners.

representatives have not been slow to seize upon the opportunity to extort funds from the bureaucracy in its attempts to carry on the business of government—introducing new laws and regulations; implementing budgetary decisions such as the removal or reduction of subsidies and the divestment of state-owned enterprises; the appointment of individuals to positions such as top military posts, ambassadorships and the governorship of the central bank; and, in particular, IBRA's attempts to divest its large portfolio of bank and corporate assets (*Jakarta Post*, January 23, 2001). It has not escaped the media's attention that members of parliament are now looking much better dressed, and driving around in much more expensive vehicles, than before (*Tempo Magazine*, 7 October 2002).

Newly active regional governments

Since power and authority were so heavily concentrated at the centre under Soeharto, one of the first priorities of the reform movement was the devolution of some aspects of government to the regions—or 'decentralisation' as it is known in Indonesia. Two laws on decentralisation were among the flurry of new laws enacted under the short-lived Habibie government (Anwar 2001: 7–13): laws numbers 22 and 25 of 1999, on *Regional Government* and *Fiscal Balance between the Centre and the Regions*, respectively. A feature of the second of these was the extraordinary decision to return large proportions of natural resource revenues to the provinces and districts where they originated; the apparent unconstitutionality of this arrangement seems to have been ignored (McLeod 2000: 31). In the past, oil and gas revenues, in particular, have played a big part in financing government expenditure throughout the nation, especially on the construction and maintenance of infrastructure (Ravallion 1988: 54). At face value, law 25/1999 greatly reduces the scope for a continuation of this, and thus provides a good example of parts of the old franchise now going their own way, regardless of the impact on other parts, and on the sense of nationhood in Indonesia. In reality, the implementation of this aspect of the law seems to bear little resemblance to what it appears to say (Fane, forthcoming).

Just as the behaviour of members of parliament has changed as more genuine democracy has created many more opportunities for them to practice extortion, the move to decentralisation has resulted in a similar change in behaviour on the part of regional governments. The devolution of some of the functions of government to provincial and *kabupaten* levels has meant that regional governments no longer regard themselves as subservient to, and dependent upon, the central government.

In other words, they no longer see themselves as having to play by the rules of the Soeharto franchise—as indeed was the intention of the decentralisation reform.

There are clear indications that regional government officials, like members of parliament at the national level, are adopting the attitude that the widespread opportunities for personal enrichment enjoyed hitherto by their central government counterparts have now shifted to the regional levels (see, for example, *Tempo Magazine*, April 22–28, 2003). One well-known example of this is the central government's attempt to privatise its cement manufacturing company, PT Semen Gresik. A relatively small shareholding in this company had been divested some years ago to the Mexican company, Cemex (Cameron 1999: 25–6). At the time of this sale, Cemex was given an option to purchase a majority stake in the company. But when it moved to exercise this option, the provincial governments in West Sumatra and South Sulawesi, where two of the company's major plants are located, moved to block the sale and, in effect, to seize control of the central government's ownership stake (Deuster 2002: 11). The case was still in deadlock and the time of writing (*Jakarta Post* 21 May, 2003), and had helped to dampen what little enthusiasm the government had for privatisation.

In another case, regional (provincial and *kabupaten*) governments in East Kalimantan, apparently acting on behalf of domestic private sector interests, have been attempting to expropriate a majority stake in the foreign coal mining company, PT Kaltim Prima (*Australian Financial Review*, 15 May 2002 and 10 February 2003). The effective usurpation of the powers of the courts, and the implicit threat of extortion by the army, as in both Aceh and Papua (*Tempo Magazine*, March 25–31 2003), have added to the concerns of foreign investors generally. Domestic mining companies have also been affected, and have cut back significantly on their investments.

The episode has had even wider implications for the economy, however. The uncertainty created by the court attachment of the Tangguh natural gas field in Papua, which is owned by one of Kaltim Prima's shareholders, is plausibly blamed for the loss to Australia of a huge contract to supply China with natural gas—even though the attachment was eventually overturned after the president intervened (*Australian Financial Review* 4 November, 2002). It is interesting to note also that in its efforts to overcome the malign impact of its own courts, the government has been forced to move even further away from its commitment to privatisation, by agreeing to purchase 20% of the 51% share of Kaltim Prima that is required to be divested under the terms of its establishment. Presumably, the original owners would never have consented to allowing the regional governments to acquire a majority stake in the company.

A further important aspect of the collapse of the franchise on regional governments' behaviour is the enthusiasm with which they have begun to impose a range of taxes within, or at, their boundaries (SMERU 2002). In some cases this is well intended, but no doubt in others it is simply a manifestation of the fact that, by imposing formal taxes, the opportunity is created for officials to generate income for themselves by negotiating effective reductions or exemptions for the taxpaying entities in question. In any case, there is no doubt that this is making life more difficult for private firms.

Turf wars between the army and the police

Another of the reforms of the Habibie era was to separate the police from the armed forces. This has led to a more overt rivalry between these two parts of the former franchise—in particular, between the police and the army—which bears an interesting resemblance to the gang wars of the prohibition era in the US. This is not surprising. Both are involved with organised crime: gambling, prostitution and drug dealing, and with the practice of extortion, which is a natural extension of those activities (*Straits Times* 22 February, 2003). The competition between them from time to time breaks into the open, such as a recent case involving drug dealing in Sumatra in which a number of soldiers attacked a police station, killing several policemen (*Asia Times*, 15 October 2002).[26] The business community can hardly ignore this kind of occurrence when it, itself, needs to rely on the police to protect its property rights. A police force that is heavily involved in organised crime is unlikely to perform this function effectively.

The challenge of *Reformasi*: regaining effective government

It is important to appreciate that the failure during the Soeharto decades to strengthen the public sector institutions' capacity to serve the public interest was no

[26] In an earlier episode, police stations in Madiun were attacked by the army, resulting in two civilian deaths and numerous injuries (*Jakarta Post*, 18 September 2001).

oversight. On the contrary, this was precisely what had helped make Soeharto strong and his extended family wealthy. His intention was to make himself safe from any attempt to remove him from office or to dilute his ability to make policy as he saw fit. Indonesia's democracy was a sham, in which there was no chance that Soeharto would be removed through the normal election process. Nor was there any chance that the legislature, the bureaucracy, the judiciary, the armed forces or the state-owned enterprises would put the interests of the people before those of the franchise.

If now is genuinely to become the era of *reformasi*, the reform will have to apply to all of these public sector institutions. Reform requires not only getting rid of Soeharto, but also either getting rid of, or changing the behaviour of, a large proportion of his former franchisees.[27] The difficulty of doing so has been underestimated, however. For example, many seem to think that reforming the armed forces requires little more than depriving them of their quota of seats in the DPR. This change will be achieved in 2004, but in practical terms the army remains as strong as ever[28]—indeed, it is probably even stronger now that Soeharto is not there to keep it under control.

PERSONNEL MANAGEMENT PRACTICES AND SALARIES AS THE KEY TO REFORM

The inadequacies of Indonesia's public sector institutions are a reflection of Soeharto's intention to encourage their officials to manage them in such fashion that they could personally benefit by exploiting their positions. He deliberately kept salaries low in the public sector institutions—especially at the higher levels—not out of any concern for the budget, but because he wanted to bring people into these positions who would be unconcerned about salary levels but would focus instead on

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[27] Earlier attempts to eliminate corruption under Soeharto were almost entirely cosmetic (Mackie 1970; Mubyarto 1984); they failed because Soeharto had no intention that they should succeed. Current efforts face what is essentially the same problem: too many people in the public sector have much to lose, yet it is those same people that the public must rely upon to minimise corruption.

[28] This view was adumbrated by William Liddle at a conference at the US–Indonesia Society in Washington DC on 'Political Succession and the 2004 Election', March 20, 2003 (summary available at http://www.usindo.org/Briefs/2003/).

the opportunities they would have to earn illicit income as franchisees.[29] By ensuring that officials within these institutions had a common interest in the effective functioning of the franchise, the president was able to co-opt them to serve his own interests.

Many young people with good intentions were recruited to these institutions as well who had every intention of doing their work well for the benefit of the public. Such individuals tended to languish in the 'dry' areas, and for the most part they found that the path to promotion was heavily restricted unless they wanted to buy into the franchise. Some of them did so, while others left to seek their livelihoods elsewhere. Many more simply accepted their fate, enduring a low standard of living, and forgoing any real opportunity for promotion to levels at which they were capable of functioning effectively.[30] A few made their way up through the hierarchy by virtue of Soeharto's recognition of the need for competence in at least some areas of policy making.

The public sector institutions *cannot be reformed* in the absence of a far-reaching restructuring of their Soeharto franchise salary scales and radical changes to their personnel management practices, especially in relation to recruitment, promotion and discipline—including bringing criminal charges against those found to have acted corruptly. Much higher salaries are needed at higher levels in the hierarchy. Salaries need to be high enough to attract honest and well motivated people, and to give them an incentive to perform well in order to achieve promotion to higher levels. It is not necessary to set salaries that would match present-day official salaries plus typical earnings from graft and corruption, however. There are many people who would be willing to work in these institutions provided that their salaries are broadly in line with those of people in similar professions working in the private

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[29] This was reflected in a noteworthy aspect of the prevailing culture—namely, a widespread awareness of differences in the availability of opportunities for graft; areas where such opportunities were abundant became known as 'wet' (*basah*).

[30] The often heard argument that public sector officials are 'forced' to engage in corruption by low salaries is an insult to those who choose not to do so.

sector, but it will be impossible to attract a sufficient number of such people unless this is so.[31]

At the same time that salary scales are restructured it will be essential to put considerably more emphasis on performance appraisal and discipline, and to reform the processes of recruitment and promotion so as to make them transparent and fair. Presumably the latter will involve formal selection and promotion committees, whose membership would be chosen so as to provide some element of outside scrutiny. Records would need to be kept of advertisements for the positions in question, applications, and justifications by committees for their decisions. A further aid to transparency would be to make promotions and appointments subject to appeal by unsuccessful applicants. These kinds of procedures have taken years, if not decades, to evolve in other countries, and to become part of the corporate cultures of the organisations in question, so all of this clearly amounts to a massive and difficult undertaking. If Indonesia is to regain effective government, however, a new set of positive and negative incentives must be created to replace those that made the old franchise so successful.

Obstacles to salary reform

The guiding principle for setting salaries should be to set them no higher than is necessary to attract people with the requisite skills and capabilities for the positions in question. Present salaries at the lower levels appear to be adequate for this purpose, so no adjustment is required. Adjustments will be necessary, however, and in increasingly large proportions, the higher the level of the position in the organisation in question.[32] It must be anticipated that this will result in strong opposition from those who miss out. People who are currently prepared to accept

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[31] Public sector salaries may be able to be kept a little below those in the private sector, to the extent employment in the former is seen to provide additional, non-pecuniary benefits.

[32] Filmer and Lindauer (2000) argue that the common perception that civil servants are greatly underpaid relative to the private sector is not supported by available evidence, claiming that extant studies that directly compare public and private sector remuneration are unrepresentative. They contend that low level civil servants are actually somewhat better paid, and that the salary shortfall in the higher echelons is much smaller than popularly supposed. The latter unexpected finding may have been driven by survey respondents having included ‘unofficial’ income in their earnings. The issue is also clouded by the existence of a wide array of allowances in addition to base salaries, including in some cases free accommodation, the use of official cars, free telephone access and so on.

their current salary level are bound to complain if people at higher levels are given salary increases when they themselves are given relatively less, or no increase at all. Political parties, mindful of their need to win seats at elections, will be only too pleased to give voice to these complaints—just as they have done, for example, when the government has attempted to reduce the level of subsidies inherent in the pricing of fuel, electricity and phone calls (Waslin 2003: 6).

Another obstacle to salary reform is the reality of the budgetary stringency to which Indonesia is now subject. It will be argued, even by those who agree in principle with a change in the salary structure, that now is not the time for it. After all, the government is finding it very difficult to finance even its normal expenditures, given the huge burden it acquired as a result of guaranteeing creditors of the banking system when it was in the process of meltdown in 1998. Indeed, this suggests another reason why it will be exceedingly difficult politically to bring about large salary increases for the upper echelons of public sector institutions. The general public is well aware that it is now having to make good the Soeharto-linked conglomerates' failure to repay their obligations to the government—even though their owners are obviously still extremely wealthy—and is rightly suspicious of the extent to which this has been the result of collusion with senior members of the bureaucracy.[33]

Counter arguments and strategies

In anticipation of these obstacles, an appropriate way forward might be as follows. First, the budget stringency argument could be used as a partial justification for not extending large salary increases down to the lower levels of the bureaucracy and the military: the government simply could not afford to do this. As we move up the hierarchy of the relevant institutions, however, the rapidly declining number of positions means that it is not out of the question to finance large salary increases.

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[33] The Megawati government, in consultation with the IMF, recently announced an extraordinary 'release and discharge' decree (Presidential Instruction No. 8/2002) aimed to obviate any possible further claim against defaulters that had been 'cooperative' in their dealings with IBRA (*Jakarta Post*, 2 January 2003). This makes it highly unlikely that the bulk of these obligations will ever be repaid, although there have been strong protests aimed at having the decree annulled.

In any case, provided they are accompanied by appropriate changes to personnel management practices, higher salaries will pay for themselves by bringing about a significant improvement the quality of management. One of the most obvious areas where this can be seen is within the Ministry of Finance, and specifically within its revenue raising arms such as the taxation directorate and the customs service. It is well-known that the ministry has failed to widen the income tax base or to extract taxpayers' full tax liabilities from them (*Straits Times* 29 March 2003), and that the customs service is rife with corruption (*Jakarta Post* 5 February 2002). Improving the quality of personnel and the incentives they face in this ministry alone could be expected to result in very significantly increased taxation revenues. Similar comments apply in relation to the forestry and mining ministries, which have a similar record of underachievement in relation to the collection of natural resource royalties.

The government could also generate much more revenue from its marine resources if reform of the navy resulted in a more serious effort to deal with illegal fishing activity (*Jakarta Post* 10 March, 2000). And with better management and a strong focus on discipline it can be expected that procurement throughout the public sector will become much more cost-efficient, resulting in large savings in outlays. In short, salary structure reform in the public sector is not only essential, but also fiscally feasible.

Second, although a new salary structure would be determined (based on an intensive study of comparable private sector employee remuneration)[34] and made public, the government *would not provide automatic salary increases to incumbents*. Instead the incumbents would be invited to, in effect, reapply for their own jobs—but at the new higher salary levels—in competition with anybody else who wished to apply, whether from within or from outside the institution.[35]

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[34] If Filmer and Lindauer (2000) are correct in their view that public sector salaries are not in fact greatly different from those in the private sector, then of course the financial aspect of the reform would pose little problem for the government.

[35] Lindsey (2001: 57) documents 'the aggressive opposition from the incumbent Supreme Court bench' to the threatened appointment of an 'outsider' as the chief justice. To offset resistance to this process in all the public sector institutions it might also be worthwhile in some cases to offer voluntary redundancy packages to incumbents who might prefer retirement to going through this process.

This in itself would be a highly significant break with current practice, which is to recruit only at base levels, implying that higher levels can only be filled by promotion from within. This practice helped to strengthen Soeharto's franchise by creating strong incentives for employees to act as their superiors wanted them to, since the only path to career advancement was upwards within the individual's present organisation. By changing this approach the government would make clear that it would not reward countless public sector officials that had abused their positions in the past, or that had been appointed to their present positions on grounds other than their competence to do the job.[36] Rather, it would only pay the new salaries to the best individuals available for the positions in question. At the same time, it would be important for the government to emphasise that the path to higher salaries would be through promotion—and that individuals could now expect to be promoted on merit.

Sequencing

If the proposed reform amounted to nothing more than salary increases, then all that would need to be done would be to determine the new salary scales and implement them. On the contrary, however, the reform is intended to get the best available people into each position, and this entails the revision of appointments throughout all the public sector institutions. Obviously it would not be feasible to undertake such an enormous task all at once. Moreover, at the very top levels, appointments will not follow the standard procedure of advertising positions and having selection committees choose between applicants. At these levels, appointments will continue to be political, with choices made by the president and his or her advisers.

An appropriate way to proceed, therefore, would be for the incoming president to make all of the ministerial appointments, and perhaps additional appointments at the very top levels in each of the ministries (in consultation with the new ministers), and then to move in the same manner in relation to the judiciary and the

[36] Such a large proportion of public sector officials have some involvement in petty corruption that it would not be feasible to exclude them all from reappointment or promotion; the sensible approach would be to ignore the past in these cases, while making it very clear that even this would not be tolerated in the future.

military/police.[37] Beyond that, the first task of those appointed to these top positions would be to advertise and fill positions at the newly determined salary scales for the next one or two levels—whether by re-appointment of incumbents, promotions, or recruitment from outside. Thus the procedure would be to work from the top down, appointing people at the new salaries, and then relying on them to repeat the process at the next levels down in the hierarchy.[38]

The armed forces as a special case

Reform of the armed forces is the most difficult area of all, since they—in particular, the army—represent a credible threat to the continuation of democratic (civilian) government. One problem is the same as with the other public sector institutions: the low level of salaries offered in the past was deliberately intended to encourage their personnel to join, and support, the franchise. Moreover, the forces were deliberately encouraged to find ways to fund their own activities (a practice that began during the independence struggle, and in which Soeharto himself had been involved in the late 1950s) (Elson 2001:60–75), which led them to become heavily involved in business activity, both legal and illegal, and in extortion. Soeharto's strategy was to appoint high level armed forces personnel who could find ways of funding their regular activities, while at the same time taking some for themselves. They in turn expected their subordinates to act in similar fashion.

Thus the problem of asserting civilian control over the armed forces is not as simple as finding enough revenue in the budget to fully fund the legitimate operations of the forces. Personnel at all levels have incomes well above their regular salaries, and in many cases their total incomes no doubt far exceed market clearing levels for individuals with similar capabilities. If the new strategy is to put a stop to military involvement in illegal activities and in taxing the private sector so as to generate additional *personal* income, then the implication is that many military officers will be

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[37] It will be up to the people to choose their parliamentary representatives, of course, but with a reformed bureaucracy and judiciary the government would be in a position to bring about reform here, too, by taking firm action against members of parliament involved in corrupt activity.

[38] Lindsey (2001: 51–2) also argues in favour of this approach in relation to the reform of the judiciary. Alas, whether as a result of strenuous opposition from the incumbent Supreme Court judges, or then president Wahid's own second thoughts about the full implications of Indonesia having a more honest and capable judiciary, these hopes came to nothing.

made considerably worse off as a result, despite significant salary increases. These officers can be expected to resist, and it must be assumed that they will be well-equipped to resist more strongly than corrupt members of the bureaucracy, for example.

In particular, it is well known that there is a close relationship between the army and the police on the one hand, and organised gangs of thugs, known as *preman*, on the other. These gangs have been used more or less as subcontractors for the purpose of extortion, and for responding to threats to the status quo—such as the East Timorese move to secede. A recent example of this is the brazen physical attack on staff of Tempo Magazine, which had published certain allegations against a businessman alleged to be involved in criminal activities such as gambling, prostitution and drugs (*Jakarta Post* 13 March 2003). The episode demonstrated clearly the existence of a mutually advantageous relationship with the police in Jakarta. Cleaning up the army and police would therefore seem to require some strategy to deal with the street gangs as well; it would be unrealistic to assume that the *preman* (and their army and police associates) would acquiesce in the face of this threat to their livelihood.

Is it possible to conceive of wide-ranging reform that, for the time being, puts the armed forces and the police in the too hard basket? Perhaps it is. It seems to me, though, that the government needs to signal a firm intention in the medium- to long-term to bring the financing of the military and police entirely within the budget, to put an end to their involvement in business activity, and to increase their degree of professionalism. It will be necessary to seek out and promote officers with high ideals, and to steadily increase budgetary allocations to the military, with an intention to push forward with this to completion within a specific time frame. At the same time, however, there needs to be an increase in the proportion of budgetary funds allocated to the police, and a corresponding reduction in the proportion to the army, given that the need for an improvement in domestic law and order is great, while external threats to the nation are limited.[39] Such an initiative would need to be complemented by making the military genuinely responsible to a civilian minister

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[39] The main external threat appears not to be from any other nation, but from pirates (*The Australian* 6 May 2003).

for defence, and by discontinuing Soeharto's practice of having the commander of the armed forces in the cabinet.

PROSPECTS FOR REFORM AND RECOVERY

The foregoing argument has suggested that the process of reform must be driven from the top down. Since it begins with the president, the question of who becomes the next president is crucial to Indonesia's prospects for reform and recovery. To be a candidate for the presidency requires the support of the major political parties, but their own actions (and inaction) as members of Megawati's coalition government suggests strongly that these parties are less interested in reform, and more interested in gaining office for the opportunities this presents for the accumulation of wealth and power. If they do have a genuine interest in reform, there is little on the public record by way of concrete, credible strategy to achieve it. It is, therefore, difficult to imagine that the approach suggested here is likely to be followed. Unfortunately, it is even more difficult to imagine effective reform by other means.

Current reform efforts

Current reform efforts rely on quite different approaches: training, and anti-corruption initiatives. The emphasis on training assumes that public sector officials desire to further the public interest, but are prevented from doing so by a lack of the necessary skills. In reality, the provision of training in a context in which officials' remuneration is far below their earning power (augmented by opportunities for corrupt conduct), and in which the link between performance and promotion is weak, is like pouring water into desert sand. It is simply naïve to expect officials to use their skills in the interests of the public unless they have appropriate incentives to do so.

Anti-corruption initiatives, such as establishment of the Commission to Audit the Wealth of State Officials, the Anti-Corruption Commission, and the National Ombudsman's Commission (Sherlock 2002), assume that what is lacking is enforcement of the norms of proper behaviour. While such mechanisms have an important role to play, they can only be expected to be effective in systems in which corruption and malpractice are the exception rather than the rule. When these problems are endemic, as they are in Indonesia, mechanisms that try to monitor and penalise officials' misbehaviour are of little use. The problem is that firm action needs to be taken against those found to be corrupt by other individuals within the same system, who are more than likely to be involved in malfeasance themselves.[40] This is evident in the failure to provide these new agencies sufficient resources or powers for them to be able to function effectively and, for example, by the president's failure to take any action against her Attorney-General, who was found to have failed to report all of his assets, and whose wealth far exceeds what he could have been expected to save on the basis of his official remuneration (*Laksamana.Net*, 3 October 2002).[41]

In short, the various internally and externally driven current efforts to reform Indonesia's public sector institutions cannot succeed, because they fail to deal with the underlying problems of unrealistically low salaries at the higher echelons, and grossly defective personnel management practices. Worse still, the focus on these other approaches lulls all concerned into thinking that something important and useful is being done about reform, which merely serves to postpone the day when an Indonesian government will face up to the real issues. In this sense, misguided attempts at reform are probably worse than none at all.

CONCLUSION

If Indonesia's democracy is to be made effective—if Indonesia is to have much of a future—it is essential that discussion of the obvious need for reform of the public sector institutions moves beyond platitudes (see, for example, Rais 2003) and presidential exhortations and lamentations (*Laksamana.Net*, 7April, 2003; *Jakarta Post* May 20, 2003) to meaningful analysis and concrete suggestions as to the nature and implementation of such reform. The suggestion presented here is that the key to reform is to provide strong positive and negative incentives to good performance throughout these institutions. They will be well managed if the individuals that comprise them find this to be in their own interests.

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[40] The Commission to Audit the Wealth of State Officials reported in mid 2002 that only 35% of judges, prosecutors and police officers had obeyed the directive to report their assets (*Jakarta Post* 22 July 2002).

[41] Coalition partner Golkar's secretary and DPR chairman, Akbar Tanjung, has also been permitted to continue in office even though having been found guilty of corruption (*Laksamana.Net* January 17, 2003).

It is hard to be optimistic as to whether much progress can be expected. Not only will such reforms be resisted by the individuals whose present behaviour is at the heart of the problem, but it seems almost inevitable that they will also be opposed by well-meaning people who imagine corruption, collusion and nepotism can be made to go away by other means. In the absence of more visionary and capable potential leaders than any on the horizon, the prospect for Indonesia's economy even to 'muddle along' at 3–4% growth seems limited.

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