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The Soeharto Era: From Beginning to End

Ross H McLeod

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The Arndt-Corden Division of Economics

**Research School of Pacific and Asian Studies
ANU College of Asia and the Pacific**

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The Soeharto Era: From Beginning to End

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Abstract

The paper develops a simple model of the Soeharto 'franchise', in which the coercive power of government was deployed in the interests of the president, his family, his business cronies and key officials within the franchise. The franchise prospered by generating rents that could be harvested by, and shared with, insider firms, and by extorting payments from outsider firms and individuals. In this model the franchise inevitably collapses in the long run for various reasons: the level of 'private taxation' from which it prospers eventually becomes intolerable; rents are diluted as franchise membership is expanded to buy off opposition; insider firms grow so rapidly that they run into financial and management bottlenecks; internal discipline declines as members compete for larger shares of the rents. The float of the Thai baht in 1997 merely provided the trigger for this inevitable collapse, while Soeharto's failing health helped to accelerate it.

Key words: franchise, Asian crisis, Indonesia, rents, private taxation, bureaucratic extortion

JEL Classification: O53, P16, P17, D72, D73

INTRODUCTION

A key feature of Soeharto's Indonesia was the symbiotic relationship between a number of private sector business groups and the regime. The government implemented a range of economic policies that enabled the so-called 'conglomerates' to earn very large profits, which were then shared with the regime – particularly, the president and his family. A second feature was that Soeharto was able to create what amounted to a political monopoly on the presidency. The effect of this was that he was able to control the behaviour of all the major public sector institutions, because individuals within those institutions were dependent on his favour for advancement of their own careers and for gaining access to lucrative positions where they could obtain very high incomes in addition to their modest formal salaries. A third feature was that the bureaucracy, the judiciary and the military were not only permitted, but also expected, to engage in extortion of firms and individuals that were not part of the ruling elite.

The system functioned very effectively for some three decades, generating rapid economic growth in which the elite and high-ranking officials in the public sector shared disproportionately. But whereas the redistribution of income from the general public to the elite was on a very small scale early in the life of the New Order regime, by the mid-1990s the very success of the system meant that a continuation of this success required increasingly heavy off-budget ('private') taxation of the general public. As a consequence, opposition to the regime increased to a level at which Soeharto's political monopoly was at risk. Moreover, as his children and grandchildren grew to adulthood, and as Soeharto himself became increasingly complacent about the strength of his position, the first family began to encroach on the privileges of the other conglomerates, seeking an ever larger share of the spoils of office for themselves.

This paper presents a simple, formal model of the system built up by Soeharto, emphasising a number of reasons why it was inherently unsustainable in the long run, notwithstanding its astounding success over some three decades. It is argued that the sudden collapse of the New Order in May 1998 is best understood in terms of a realisation on the part of big business that the system that had made it so wealthy was now on the road to capture by the first family, and that in any case it was unlikely to survive the seemingly imminent departure of the president as a result of either ill health or death, there being no potential successor capable of imposing the same degree of discipline on the public sector institutions as had been required in the past. In these circumstances, the owners of the conglomerates had already begun to diversify their balance sheets away from Indonesia, and the

financial crisis that began in the second half of 1997 simply added much greater urgency to this process. In turn, the rush to preserve wealth accumulated during the Soeharto era made the crisis all the more severe.

The economic policymaking community, centred mainly on the central bank and the finance ministry, proved quite incapable of handling the sudden and unexpected disturbance triggered by the float of the Thai baht in mid-1997. Indeed, policy responses made the crisis far worse than in the other affected countries, and far worse than it need have been. In part this was a reflection of a strategy for personnel management within the public sector that emphasised loyalty to the regime rather than professional competence, although this was compounded by inappropriate intervention by the president himself and by poor policy advice from the IMF and the international community in general.

GOVERNMENT AS AN INSTRUMENT OF PERVERSE INCOME AND WEALTH REDISTRIBUTION

I begin by developing a model in which the authority of government is somehow captured by a small elite, which then sets about using its newly acquired coercive power to redistribute income from all other citizens to itself by the imposition of 'private taxation'. The approach elaborated here should be distinguished from earlier treatments of government in the public choice literature, a key advance in which was to drop the implicit assumption that government bureaucrats strove selflessly to promote the public good—assuming instead that they, like everyone else, were motivated by self interest (see, for example, Buchanan and Tullock 1962; Krueger 1974; Posner 1974). This literature, very largely built up within the context of democracy as practised in the US, took for granted a free and fair electoral system in which the government of the day was obliged by the threat of being voted out of office to constrain the pursuit of bureaucratic self-interest. The present paper replaces the implicit assumption of free and fair elections with an assumption that the government itself—or, more precisely, its leader—deliberately and successfully sets about acquiring, and maintaining, a political monopoly. Whereas a large part of the earlier literature focuses on 'rent-seeking', a key emphasis here is on 'rent generation and harvesting'.

The means by which the elite taxes other citizens for its own benefit is the set of arrangements to be elaborated below, and characterised here as 'the Soeharto Franchise'.¹ I assume that the general character of economic policymaking, apart

¹ This concept has been discussed in several earlier papers, including McLeod (2000 and 2005a).

from the policies intended to raise private taxation revenue, is basically sound from society's point of view: monetary policy keeps inflation under control and the currency relatively stable, while fiscal policy avoids any rapid accumulation of public debt, and creates physical infrastructure in line with the needs of the growing economy.

I assume further that under these conditions the economy can grow at the rate g per cent per annum, and that the members of the elite want their incomes to grow at the rate h per cent per annum, where h is significantly greater than g . Initially the ratio of elite to non-elite per capita income is a , and per capita income of the non-elite is normalised to 1.² Private tax at the rate τ is imposed on all non-elite members in order to augment the incomes of the elite. Prior to this income redistribution, both members' and non-members' incomes grow at the same rate as that of the economy. The other variables of interest are the elite population (E), the non-elite population (N), and the ratio of these, $e = E/N \ll 1$.

In year t , elite pre-transfer income is $Ea(1+g)^t$, while its target income is $Ea(1+h)^t$. Non-elite pre-tax income is $N(1+g)^t$.

The required income transfer to the elite is $Ea[(1+h)^t - (1+g)^t]$, so the tax rate is given by

$$\tau = Ea [(1+h)^t - (1+g)^t] / [N(1+g)^t],$$

which can be re-expressed as

$$\tau = ea\{[(1+h)/(1+g)]^t - 1\}. \tag{1}$$

That is, the tax rate depends on the ratio of elite to non-elite populations, the initial ratio of elite to non-elite per capita incomes, the desired growth rate of elite incomes, the growth rate of the economy, and time.

Equation (1) neatly sums up the basic idea of the franchise model. The key concepts are quite straightforward: a small elite seizes and holds on to political power, and uses the coercive powers of government to privately tax the general public in order to redistribute income to itself and thus to achieve a higher rate of growth of its own income than that of the economy as a whole. The important characteristic to note,

² I shall assume later that elite per capita income exceeds that of the non-elite, but not that elite incomes are *all* higher than non-elite. The distributions of the two groups may overlap, so the elite/non-elite distinction is not the same as the rich/non-rich distinction.

however, is that although these arrangements are perfectly workable for a time, they are inherently unsustainable in the long run.

Recalling that $e \ll 1$, it can be seen that τ is small initially. For example, if $e = 1\%$, $a = 2$, $g = 5\%$ and $h = 15\%$, then in the first period ($t = 1$),

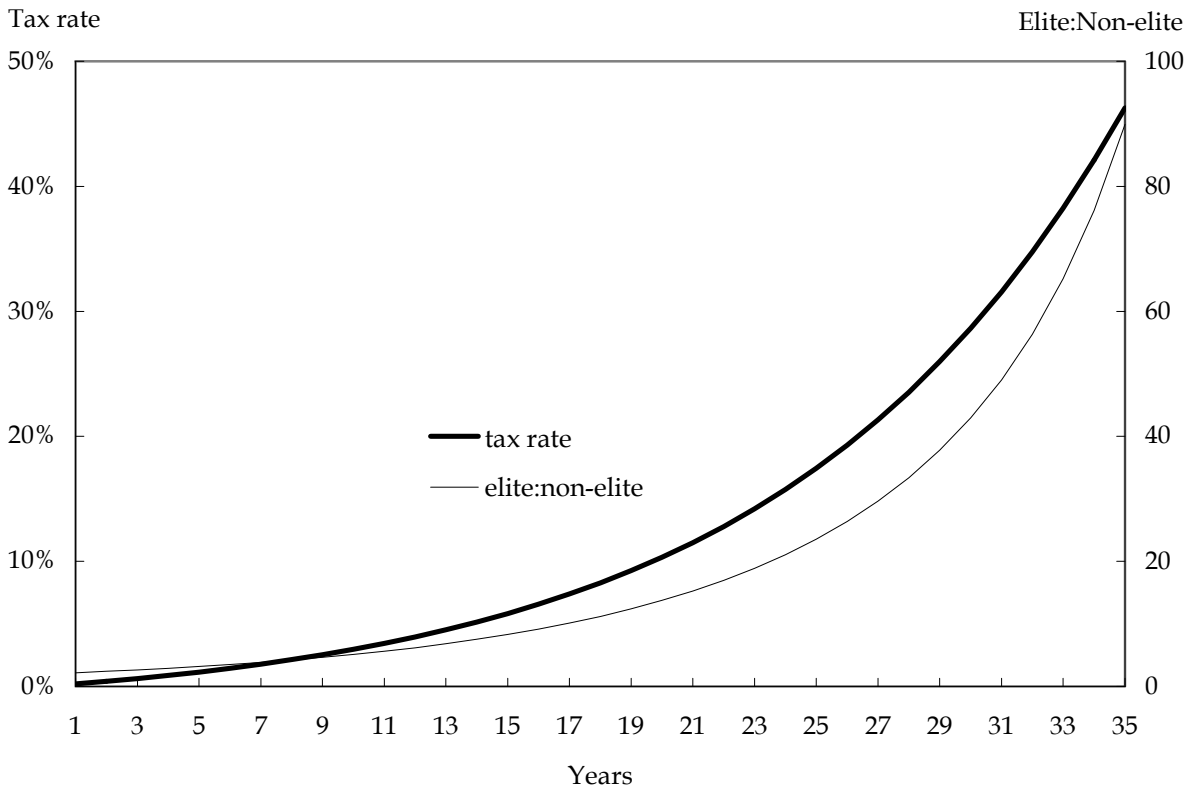
$$\tau = 0.01 \times 2(1.15/1.05 - 1) = 0.0019 \text{ or } 0.19\%.$$

That is, the implied rate of private taxation required to increase incomes of the elite at three times the rate of economic growth is just less than 0.2%, which would have virtually no noticeable impact on the general population or on the level of economic activity – and no appreciable political impact.

This tax rate increases over time, however. In the above example, by the time $t = 10$, the tax rate has increased to 3% – almost 16 times higher, but still not particularly burdensome – but when $t = 20$ it is as high as 10.3%, and after three decades it is approaching 30%. In short, the elite will have little difficulty achieving its objective in the early years, but this becomes more and more difficult over time, because the non-elite needs to be taxed increasingly heavily. At some point non-elite after-tax incomes actually begin to decline in absolute terms, as the impact of increases in the tax rate begins to outweigh growth in pre-tax incomes; on the assumptions used here, this occurs after about 32 years. Indeed, if the arrangements could be kept in place, the non-elite would eventually be left with nothing at all, as the tax rate required to keep non-elite incomes growing at the target rate rises to 100%; this occurs in the current example at about 43 years.

Figure 1 shows the evolution of the tax rate and the ratio of elite to non-elite incomes over time, while Figure 2 shows elite, non-elite, and total income. These charts are not empirically based, of course, but in this hypothetical case the time period until non-elite after-tax incomes begin to decline absolutely corresponds roughly with the period during which Soeharto was in power. For simplicity, I have assumed that the population and its composition (elite relative to non-elite) are constant. As in the arithmetic examples above, the assumed growth rate for the economy is set at 5% p.a. – roughly equal to the average rate of per capita income growth during the Soeharto era – and the elite population is 1% of the non-elite population. Its average income is twice that of the rest of the population at the outset, and the target rate of growth of elite per capita income is 15% p.a. (i.e. three times as fast as total income per capita growth).

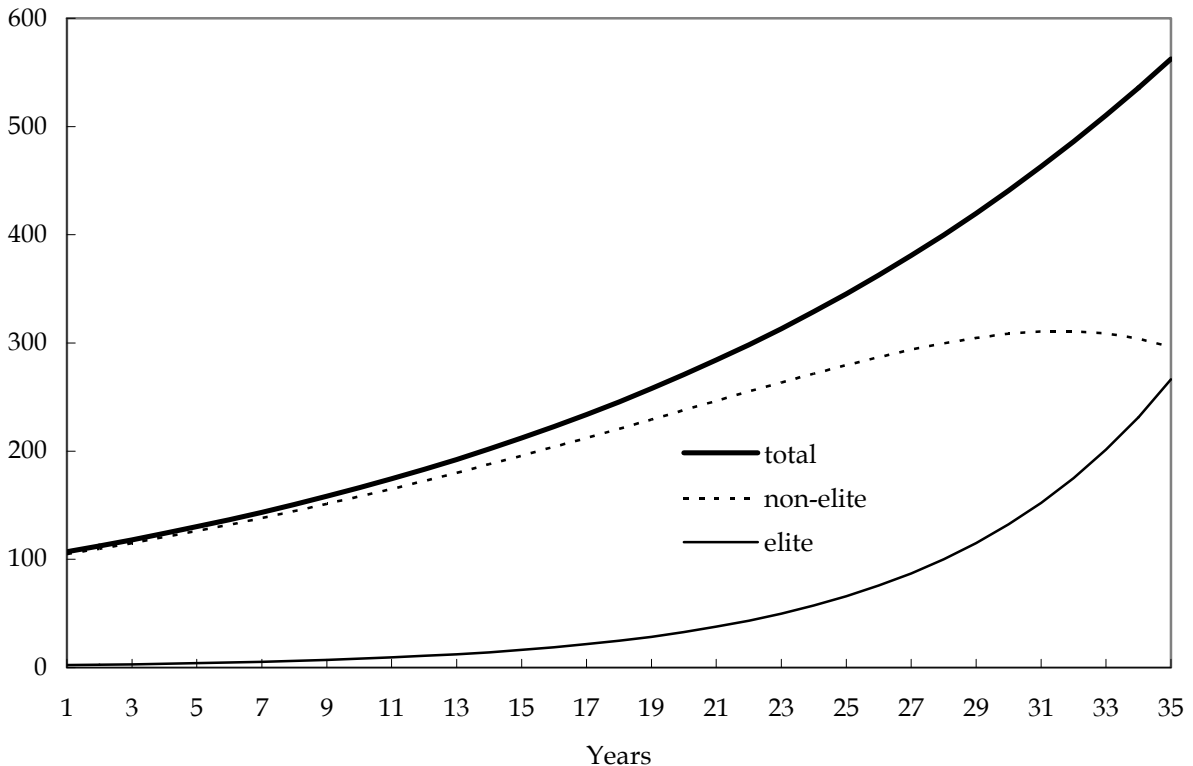
Figure 1 Tax Rate and Ratio of Elite to Non-elite Per Capita Incomes



Although average income of the elite is just twice that of the rest of the population initially, this ratio increases enormously over time. In the early years this is ‘easy’, in the sense that it can be achieved with a very low rate of private taxation – given that the elite are relatively very few in number. But as time goes by it is necessary to increase the rate of private taxation roughly exponentially³ if the elite are to be able to continue to enjoy the same rate of growth of their incomes: by year 30 it has risen to 28.6%, and elite incomes are 43 times higher than those of the non-elite. Precisely because the elite has been successful in the past, it needs to tax the non-elite more and more heavily if it is to continue to meet its income growth target. The ratio of elite to non-elite incomes increases over time, thus increasing the tax rate that needs to be applied if success is to continue. This constitutes a key inherent weakness in the system, as we shall discuss in some detail below.

³ Since $f \ll 1$, equation (1) can be rewritten as $\tau \approx fa [(1+h)/(1+g)]^t$.

Figure 2 Elite, Non-elite and Total Income



APPLYING THE FRANCHISE MODEL TO SOEHARTO'S INDONESIA

Private taxation for the purpose of redistributing income from the general public to the elite is a crucial component of the analysis presented above. So far, however, we have said nothing about the precise form it takes. It has often been argued that 'taxation is theft', and that is undoubtedly true in the present context. It has also been said that the difference between a professional thief and an amateur is that the former leaves his victim unaware that he has been robbed. With this in mind, it seems plausible to argue that a private taxation franchise will increase its longevity by finding ways to tax the general public that leave the latter unaware of what is going on.

Designing private taxation

Soeharto applied the 'professional thief' concept in three important ways. First, he taxed assets of the general public in the form of natural resources. Article 33(3) of the Constitution makes it quite clear that these are owned by the general public (notwithstanding the fact that there is no other documentary evidence of ownership), since their exploitation is to be controlled by the government for their general benefit. Taxing these kinds of assets is quite different from taxing assets such

as land or houses or cars. In all these cases, the owner needs to make a payment to the taxing authority, which has a direct, negative impact on cash flow. By contrast, although many members of the population may be broadly aware that certain individuals are being given privileged access to natural resources, they do not feel any direct impact when a tree is cut from the forest, or oil is pumped from the ground, or copper ore is extracted from a mine, so Soeharto was able to hand out rights to exploit these kinds of resources for the benefit of the elite rather than the general public, for the most part without generating much resistance.

Second, in similar fashion, Soeharto effectively taxed the assets of state-owned enterprises, which are also clearly owned by the general public—again with no documentary evidence of ownership. For example, the state enterprises could be privately taxed by using them to employ particular individuals—not for the contribution they could make to profits, but as a means of generating support for the franchise, or rewarding individuals who had shown loyalty towards it, or for buying off individuals who might otherwise pose some kind of threat to the regime.

Third, he taxed inflows of international aid from bilateral and multilateral donors, which, of course, were intended to benefit the general public and, in particular, the poorer members of society. All such aid flows involved procurement by the Indonesian government, and officials (members of the franchise) never faced any great difficulty in obtaining significant kickbacks from firms awarded overpriced contracts. Again, the impact of this form of private taxation would not have been felt by ordinary Indonesians.

A fourth means of surreptitiously taxing the general public involved private firms affiliated with the franchise as the instrument—as distinct from the object—of taxation. Firms affiliated with the franchise were provided with a range of privileges by the bureaucracy, in most cases involving protection from competition from other firms. Protection against imports was provided in the form of high tariffs, quantitative import restrictions and import bans, and local content rules for the production of goods such as motor vehicles. Protection against foreign firms was provided by denying them licences to operate locally or restricting their operations (for example, allowing very few foreign banks to operate in the domestic market and restricting them to having only one branch in addition to their head office). Protection against foreign buyers of domestically produced inputs was provided by banning or taxing the export of such products (such as logs, rattan, rubber and palm oil). Protection against other domestic firms took the form of the grant of monopoly rights to produce goods and services for the local market (such as wheat flour and the screening of movies); by the award of government contracts without the need to

tender for them in competition with other firms; and by the supply of input goods and services (such as petrochemicals and airport facilities) and loans by state-owned enterprises and banks, respectively, without the need to pay market prices or rates of interest.

By providing 'insider' firms with privileges such as these, their profitability was considerably enhanced. The supernormal profits they were able to earn were then shared with the franchise. In all cases, this amounted to the imposition of tax on the general public. Either the selling prices of goods and services produced by these insider firms became higher than they would have been under competitive conditions, or the prices at which they purchased goods and services produced by state enterprises—indirectly owned by the general public—became lower than they would have been under competitive conditions. But once again, individuals and firms would not have been particularly conscious of the fact that they were being taxed in this way. They had no real way of knowing whether the prices they were paying for their purchases contained a large element of supernormal profit, nor of knowing the extent to which the profitability of state enterprises was being depressed.

These processes by which the franchise generated rents to be harvested by insider firms and then shared with it amounted to very efficient—and politically relatively painless—forms of taxation. Although the taxes were effectively being paid by the entire population, this could be achieved by way of arrangements involving a very small number of large firms. Moreover, by contrast with the usual problem with taxation—namely the natural inclination of the taxed entity to find ways to avoid the grasp of the taxing authority—in this case the franchise and insider firms were working in a cooperative relationship in order to indirectly tax a largely unsuspecting general public. Huge amounts of revenue could be collected without the need for a similarly large tax administration effort.

In contrast with the several techniques just outlined, the franchise also collected private tax revenues through extortion. While insider firms harvested the rents generated for them by the bureaucracy, other 'outsider' private sector firms and individuals served instead as targets for predation. Franchisees within the bureaucracy and the military/police were expected by Soeharto to use the coercive power of government to generate additional income via the extortion of these individuals and firms, including smaller foreign firms, and to share the proceeds with him. Bureaucratic extortion usually took the form of requiring bribes as a condition for the issue of licences and other official documents, the delivery of normal public services, and so on, while extortion of a more overtly criminal nature,

involving the use or threat of violence, was undertaken by the military,⁴ often working through private sector sub-contractors – thugs and criminal gangs known as *preman* (Ryter 1998).

INHERENT LONG RUN UNSUSTAINABILITY

By any measure, the Soeharto franchise was spectacularly successful in its objective of generating wealth for the elite. Pre-crisis estimates of the net worth of the Soeharto family run to many billions of dollars, while cronies such as Liem Sioe Liong became among the richest individuals in Asia. Countless high-level bureaucrats, military officials, state enterprise managers and judges became fabulously wealthy relative to their pitifully low official salaries. One of the keys to success was the fact that the regime was able to maintain a very high average annual rate of economic growth (well over 7% in real terms) over some three decades; very few countries in the world are able to boast a similar achievement. But the regime collapsed in fairly spectacular fashion in 1998, sending the economy into a very deep recession. To help understand this collapse, the following discussion suggests a number of reasons why a franchise operating very successfully along the lines just described is likely, nevertheless, to be unstable in the long run.

Excessive tax rates

The first is immediately evident from the simple model presented above: the steady increase in the required tax rate. High levels of taxation (regardless of whether tax revenue is directed to purposes of state or to private pockets) tend to kill off economic activity. The incentive to work and to invest falls to zero when the stage is reached where all income thus generated is taxed away. Moreover, there are costs involved in collecting tax (again, regardless of whether for public or private purposes), and it is reasonable to assume that these increase at an increasing rate as the tax rate becomes higher; thus the system becomes increasingly wasteful over time as more and more resources are devoted to avoiding paying taxes, on the one hand, and to enforcing payment, on the other.

A consequence of the rapidly increasing amount of revenue needed if the franchise objective is to continue to be met is that 'easy' sources of private tax revenue eventually become limited relative to these needs. In the Indonesian case, some of

⁴ Soeharto himself had previously been involved in such activity, and 'was dismissed from his position as commander of the Diponegoro Division in Central Java in October 1959 for demanding money from local businesses' (Rieffel and Pramodharwardani 2007: 31).

the easy tax bases—the low-hanging fruit—were diminishing stocks, rather than ongoing flows. Oil reserves, for example, are finite (except to the extent that increasing oil prices and improved technology extend the margin of economic fields) and, in any case, Indonesia's production was constrained by its OPEC quota. Forest reserves were vast, but the scale of logging increased to such an extent that Indonesia quickly became a major player in the world market, so further increases in forest production could only be at the expense of lower prices. Likewise, the scope for continuing to strip assets from the state enterprises was limited by the size of their balance sheets. Because of both their inefficiency and the fact that they had served as cash cows, they grew more slowly than the rest of the economy, and far less rapidly than elite incomes.

When the tax base was a flow rather than a stock, the problem was that such flows tended to increase only at roughly the rate of growth of the economy, whereas for the franchise to meet its objective, private tax revenues had to grow much more rapidly than this. Gross international aid flows no more than kept up with the growth of the economy, and an increasing proportion of total revenue had to be devoted to servicing government borrowings accumulated from earlier years, thus constraining the scale of government procurement—which is where the tax was levied.⁵ Finally, the scope for boosting insider firms' profits by the creation of monopoly positions for them was also limited by the growth rate of the economy, since monopoly rent depends on the size of the market in question, and by the fact that a large part of the economy does not lend itself to monopoly operations.

Over time, a franchise such as this will therefore be forced to rely more and more heavily on various kinds of extortion, the impact of which will be much more directly felt by the general public, and which will therefore result in greater tax avoidance efforts. One of the ways in which tax avoidance will be manifested is in more vigorous opposition to the regime because of its increasingly obvious predatory nature. In short, one of the longer-term risks to the system is steadily strengthening opposition from outsiders to the imposition of private taxation, precisely because the franchise is so successful in meeting its immediate objective. Although the Soeharto franchise deployed the coercive powers of the bureaucracy, the judiciary and the military to fend off opposition of various kinds, it was by no means totally successful in this. Opposition strengthened over time with increases in

⁵ Budgeted development spending as a proportion of total government spending averaged 51% during 1976/77 through 1985/86, but only 37% during 1987/88 through 1996/97.

private tax collections, as the model predicts, becoming especially noticeable during the mid-1990s (Aspinall 2005).

Dilution of franchise rents

A second reason for long-term unsustainability of the franchise is that the rapid increase in the ratio of elite to non-elite incomes results in strong competition to join the elite: to change status from outsider to insider. There is a very close analogy here with one of the most basic ideas of microeconomic theory – that when supernormal profits exist, new firms will try to find ways of competing for those profits. In the present case, competition will take the form of individuals trying to ‘grab a piece of the action’, by threatening the regime in some way if they are not admitted to a share of its benefits. In the face of such a threat, the franchisor has basically two choices. He can simply refuse entry, in which case the contending party would continue to be taxed privately rather than sharing in the franchise revenues, thus risking strengthening opposition to continuation of the status quo. Alternatively, he can avoid such opposition by co-optation – buying off potential opposition by bringing the individuals or organisations concerned to the inside. The longer-term problem with this approach, however, is that with an increase in the ratio of the elite population relative to the non-elite, either tax revenue must be increased proportionately (which is difficult), or there must be some sacrifice of the growth rate of elite incomes (which weakens support for the franchise).

This process was clearly evident during the life of the Soeharto franchise. It was, perhaps, accentuated by the fact that by far the majority of insider firms were owned by ethnic Chinese individuals. Thus it was not long before the majority *pribumi* (indigenous) business community began to press its claims for inclusion. In response, for example, small farmers became the beneficiaries of cheap credit and subsidised fertilisers and other inputs, while small businesses were also targeted with subsidised loan programs.⁶ Regulations were introduced that gave *pribumi* firms a privileged position in government procurement (Daroestan 1981: 15–16, Wells and Ahmed 2007: 110). And a small number of large *pribumi* firms were given cheap access to Indonesia’s abundant mineral resources.

⁶ In practice, much of the subsidy was diverted to officials in the state-owned banks that handled these programs, who had considerable discretion as to who received loans and who did not. The subsidy element was therefore reduced by the need to share it with these officials.

Financial and management bottlenecks

A third reason why the arrangements outlined in the model are likely to become more and more troubled over time is rather more complex. As already discussed, one of the main means of privately taxing the general public is to implement economic policies that artificially boost the profitability of businesses affiliated with the franchise. But in order to generate ever-increasing profits, these firms have to undertake increasingly large investments, in more and more unfamiliar activities. This has two important consequences. First, the financing requirements also increase rapidly, and will eventually exceed the capacity of the domestic financial system; in turn, this will force these firms to look to global financial markets for funds. Second, the insider firms eventually will begin to be hampered by a lack of the high level professional skills needed to manage and operate large and technologically sophisticated businesses.

Again, there is some scope for turning to the rest of the world for these skills, perhaps by way of joint ventures with foreign multinationals, and this was certainly apparent in various fields of economic activity. In practice, however, it is much more difficult to import very highly skilled managerial labour to a country such as Indonesia than it is to import capital because of the language barrier, cultural differences, the need of foreign managers to accommodate the educational needs of their children and the careers and preferences of their spouses, and so on. In such circumstances it is very likely that the quality of management will fall short of what is required, making the firm vulnerable not only to foreign financiers' mood swings but also to the possibility of large losses as a result of management errors.

Declining internal discipline

A fourth factor contributing to long-term unsustainability is competition and conflict among insider firms and franchisees seeking a larger share of the spoils for themselves, particularly when the absolute amounts become very large. (The analogy from basic microeconomic theory is the tendency for members of an oligopoly to cheat by producing in excess of their quota.) If carefully managed this does not necessarily result in or contribute to long-term collapse. It boils down to a question of the capabilities of the franchisor, for whom one of the major tasks is to act as the arbiter of such conflicts. The danger is that if a powerful party is disappointed by the outcome, loyalty to the franchisor might be transformed to significant opposition.

For the most part Soeharto handled this problem skilfully. He was particularly adept at playing one franchisee off against another, rarely coming down clearly on the side of one or other of the contending parties, and usually leaving both in the hope of being able to improve their position in the near future provided they continued to display loyalty to him and to deal effectively with their assigned tasks. This was particularly evident in the case of the military, where various individuals' stars waxed and waned over the years. Whereas Soeharto was at best a first among equals at the beginning of the New Order, by the end he was very much the master, having seen off the likes of Generals A.H. Nasution, Ibnu Sutowo, Ali Moertopo, Sumitro and Benny Moerdani,⁷ and was still keeping the ambitious Generals Prabowo Subianto and Wiranto dangling in the hope that one and not the other would eventually come out on top.⁸

It would appear, however, that Soeharto's success in consolidating his position as the unchallenged 'owner' of the franchise eventually blinded him to the fact that he could only maintain its internal coherence if those who benefited from it—in particular, the major players—felt that they were obtaining a fair share of the pie, both relative to each other, and to the first family. It has often been observed that Soeharto's biggest problem was his children's greed, which became increasingly obvious in the late 1980s and the 1990s (Abdulgani-Knapp 2007). The key focus here has usually been on an extremely wealthy family seeking to become even more wealthy at the expense of the general public.

Perhaps no better example can be found than the (failed) attempt of Soeharto grandson Ari Sigit to monopolise the sale of shoes to schoolchildren (Backman 1999: 281-2). But other members of the elite were also victims of this rapacity. We could mention son Tommy's monopoly of the trade in cloves at the expense of both cigarette manufacturers and clove farmers; Tommy's national car project, which was given valuable tax concessions not available to other car assemblers; Ari Sigit's attempt to tax beer in Bali to the detriment of the tourist industry there; and so on (Backman 1999: 267-72). Nor was this purely a matter of first family versus the rest of the elite: there is plenty of evidence of rivalry between the Soeharto children themselves. Moreover, the notion of Soeharto as the doting father simply unable to resist the demands of his children ignores the evidence of his own greed. This comes out very clearly in the history of exploitation of Indonesia's forest resources (Barr

⁷ See, for example, Elson (2001:206), Steele (2005: 83).

⁸ See, for example, O'Rourke (2002: 72).

1998), which Soeharto used initially to build support among military officials by granting them logging concessions. Some years later, however, when he felt much more secure in his position, he set about recapturing these natural resource rents, working through his right-hand man Bob Hasan: the tsar of the forestry sector.

It is unnecessary to go into detail here. Suffice it to say that Soeharto and his family demonstrated by their actions that they had little hesitation in sacrificing the interests of other members of the elite after he found, or came to believe, that they had served their purpose and were now dispensable. Most of the cases just mentioned were mainly noteworthy for the degree to which they generated revulsion on the part of the general public—or at least the intelligentsia—toward the greed of Soeharto's children. But at the same time they sent out an unnerving message to other members of the elite, especially the extremely wealthy, ethnic Chinese conglomerate owners. To be sure, they had prospered mightily as a result of their insider status with the franchise, but more and more it began to seem that this status was under threat.

Demographic aspects

There is one final matter that bears upon the long run sustainability of the franchise: human mortality. By contrast with franchises in the world of business, in which the owner of the franchise is actually a company with a potentially infinite lifespan, the public sector franchise is headed by a mortal individual. That individual obviously needs considerable political skill and a range of other talents, so the question naturally arises as to succession. And indeed, the succession issue was a perennial topic of conversation for many years under the New Order. By the mid-90s Soeharto himself was in his mid-70s—quite old by Indonesian standards of life expectancy. To what extent he thought about a replacement for himself we can only guess. Casual observation suggests that he probably considered anointing one of his military proteges as his successor, although toward the end it seemed that his eldest child, Tutut, was being groomed to take over.

Soeharto's children were still young when he came to power, but by the late 1970s as young adults they began to make their presence felt in the business world, and by the 1990s their greed and their lack of concern for fellow citizens had become all too obvious. For its part, the military was also despised by many for its cruelty in support of the regime, and its involvement in criminal activities and extortion. Whereas the general public had put up with Soeharto, increasingly grudgingly, as their unchallengeable political leader for three decades—no doubt because at least he had delivered significant economic benefits to most of them during that time—there

is little doubt that there would have been immense disquiet if either a military official or one of the president's children took over this role. It was therefore inevitable that individuals among the elite and the franchise would become increasingly concerned over time about what would happen when Soeharto died or became incapacitated. There appeared to be no individual on the horizon capable of stepping into his shoes and being able to impose the same level of discipline on the franchise – without which it was bound to disintegrate.

THE CRISIS

In the midst of the crisis Hill (1999: 76) argued that it 'was not inevitable' and that 'it could well have been the case that if even two or three of [several key parameters] had been more favourable in 1997-98, then Indonesia would not [then have been] engulfed' by it. In other words, Indonesia's crisis could perhaps be attributed to the unlucky conjuncture of a number of adverse circumstances.⁹ More recently, Chua (2008: 99) has asserted that '[t]he crisis in 1997/1998 unravelled Indonesia's successful business model of close state-business relations', seemingly implying that in the absence of the crisis this unravelling would not have occurred. By contrast, I argue here that the business model was unsustainable, and that its eventual disintegration was very likely to precipitate – rather than be precipitated by – economic and political upheaval.

The franchise model outlined above not only provides a framework for interpreting the way the Indonesian economy and polity operated over a period of some three decades under Soeharto, but also suggests that such franchise arrangements are inherently unsustainable in the long run – especially if the franchisor becomes complacent about his ability to maintain discipline within its elements and seeks to appropriate an excessive share of its revenues for himself. The model is not deterministic, and certainly provides no basis for predicting when the end will come, much less the form it will take. In qualitative terms, however, we now have a sufficient basis for extending the discussion to encompass the demise of the Soeharto franchise in May 1998. The steady increase in the required rate of private taxation, combined with the progressive exhaustion of 'easy' tax bases, provoked increasing opposition to the regime, to the extent that Soeharto's political monopoly – and therefore, his ownership of the franchise – was at risk. Strategic choices to admit various individuals and organisations to the elite served by the franchise had diluted the returns to its original membership, and the greed of the first family was tending

⁹ '... practically *everything* went wrong at once ...' (Hill 1999: 48).

to exacerbate this by progressively changing the status of many insiders to that of outsiders. Finally, the president's advancing age and the absence of any obvious successor made the future highly uncertain for both franchisees and the elite in general.

It was in this context that Thailand unexpectedly floated its currency, in July 1997. In retrospect, it can be seen that this was the straw that broke the back of the franchise.¹⁰ The ethnic Chinese conglomerates already had good reason for concern about the safety of their assets. On the one hand, their hitherto privileged position was increasingly coming under attack from the first family. On the other, it had become more and more obvious that Soeharto's days were numbered, that there was no credible successor to him as franchise owner, and that the franchise was therefore bound to disintegrate before too much longer, with unpredictable consequences. Added to this, precisely because the franchise arrangements had been so successful in boosting the wealth and scale of these conglomerates, several of them had simply outgrown the Indonesian market. For all of these reasons some of them had already begun to diversify their balance sheets by establishing or acquiring new businesses overseas, particularly in the rapidly growing economy of China, where they could make use of their networks of family and friends.¹¹ The float of the Thai baht, and its immediate and large depreciation, added significantly to the urgency of implementing this new strategy because the private sector was heavily exposed to the risk of rupiah depreciation, which had seemed highly unlikely until then; as a result, the franchise chickens began to come home to roost in rapidly increasing numbers.

Recall also that, by virtue of its very success, the franchise had stimulated the asset growth of crony conglomerates to such an extent as to outrun domestic financing capabilities, causing them to turn to the global financial market for loans and equity injections. The result was that there had been a surge in foreign borrowing, alongside considerable foreign portfolio investment in the Jakarta Stock Exchange, in the mid-1990s (Matsumoto 2007). But by 1997 it was possible to shift very large

¹⁰ Or, perhaps, the first of two such straws. The second was that Soeharto's health was suddenly called into question in early December 1997, before the crisis had become severe. The president was obliged to cancel an overseas visit at this time for health reasons – the first occasion on which this had happened.

¹¹ This had not shown up in the balance of payments, however, because it was offset by the continuing enthusiasm of foreign portfolio investors and lenders to increase their exposure to Indonesia.

amounts of financial capital across international borders with alarming speed, and that is precisely what began to happen. Balance sheets began to be quickly reoriented so as to reduce exposure to Indonesia. Assets were acquired overseas and assets in Indonesia sold; debt denominated in dollars was repaid, and new rupiah-denominated debt was incurred.

In short, whereas previously there had been strong and sustained capital inflow leading to a considerable build-up in Indonesia's foreign exchange reserves, suddenly—and much more rapidly—the reverse began to occur. Large capital outflows disrupted the established trend of depreciation of the exchange rate, and reserves began to decline. The disturbance was so severe that the government felt obliged to announce, without any warning, that it had decided to follow the lead of the Thai central bank by floating the currency. It was hardly prepared for what followed, however. Rather than quickly settling at a new equilibrium, the value of the rupiah began to plunge to unimagined depths.

Forgetting Keynes

Interestingly enough, although macroeconomic policymaking—or, at least, policy discourse—during the previous three decades had been dominated by Keynesianism to the virtual exclusion of monetarist ideas, when the crisis began to gather momentum in late 1997 the Keynesian fundamentals were abruptly forgotten. Whereas Keynes had persuaded post-WWII governments around the world that they should increase their budget deficits at any time private sector spending declined noticeably—in other words, that they should practise counter-cyclical policy so as to keep the level of aggregate demand fairly steady—the very first change to fiscal policy in late 1997 was precisely a move in the opposite direction (McLeod 1998a: 922–4). 'Austerity' was the key word, just as it had been at the beginning of the Great Depression of the 1930s. Government spending had to be decreased and revenues increased in an attempt to give the financial markets what it was supposed they wanted. For good measure, there was some *pro*-cyclical monetary policy as well: the money supply was quite drastically reduced by forcing certain large state enterprises abruptly to shift funds to the central bank, leaving the banking system desperately short of liquidity.

Explaining the policy choices

There appear to have been two components to the thinking behind these ill judged policy responses to the sudden decline of the rupiah, and both of them had to do with opposition to the Soeharto franchise (which, as we have seen, had strengthened

steadily as the rate of private taxation had increased and the rapacity of the first family became ever more apparent). Part of this opposition actually came from within—from the main economic policy making parts of the bureaucracy, led by the so-called ‘Berkeley mafia’ (or ‘technocrats’) and their proteges. Like others within the New Order public sector institutions, this group had had to choose whether to remain silent about their concerns regarding Soeharto’s abuse of his position, or to speak up—with the almost inevitable consequence that they would be, at best, sidelined, thus losing any capacity to influence the course of Indonesia’s development for the better. They chose to stay on the inside, and from time to time as circumstances as dictated they tried to persuade their boss to change various policies and personnel (Thee 2003: 36). When the crisis emerged in 1997 they saw it as an opportunity—not to bring down the regime, but to press for a range of changes to microeconomic policymaking, emphasising, in particular, the blocking of various large-scale but probably uneconomic projects sponsored by the first family. They had strong support from the World Bank and the IMF, and they encouraged the latter to put pressure on the president to change these policies as a precondition for its financial support in responding to the crisis. In short, a key feature of the fiscal austerity moves just mentioned was cancellation or postponement of various infrastructure projects with first family and crony involvement. By this means, it was intended to signal to the entire business world, inside and outside Indonesia, that the government would be more serious in the future about designing economic policy in the interests of the general public rather than insider firms, particularly those of the first family.

The second factor underlying policy choices at this time appears to have been a belief that the financial markets were demanding, in effect, that Soeharto should be made to kow-tow to economic orthodoxy as interpreted by the IMF and the World Bank. If the IMF could bludgeon the president into agreeing to a long wish-list of changes to microeconomic policy—most of which had little, if anything, to do with the immediate balance of payments problem—then speculation against the rupiah would cease. Economic conditions would then return to normal, except that Indonesia would henceforth follow the righteous path of pure neo-classical economic policy. In short, the markets supposedly wanted to see ‘blood on the floor’—Soeharto’s blood—not the result of a dagger to the heart, perhaps, but at least from a punch on the nose. But the belief that policymakers could discern what ‘the markets’ wanted lacked any basis in reality, and seems to have been driven by the rather noisy community of money market and foreign exchange traders. The far more important part of ‘the markets’—the business community in Jakarta,

dominated by insider firms—sat anxiously in the background, seeing its position eroding by the day.

Compounding initial errors

All of the initial policy moves turned out to be counter-productive. In a context in which the private sector was rapidly losing confidence, the government had withdrawn liquidity from the economy, and had begun to postpone and cancel large projects and procurement. Perhaps more important than this, however, was that everything that was happening had the effect of confirming insider firms' perceptions: first, that their days of privilege were about to come to an end; and second, that the failure to build up competence in the bureaucracy that resulted from franchise personnel management strategies (which rewarded loyalty to the regime over competence) meant that Indonesia's economic managers lacked the skills to deal with the emerging crisis. These insider firms had by now come to occupy a very significant role in the economy, but the crisis-induced policy changes cut the ground from under their feet. It is hardly surprising, in retrospect, that the outflow of capital quickly became a flood.

Over the next several months, subsequent modifications of policy served only to amplify the crisis. Having first brought the banking system virtually to its knees by cutting the banks' aggregate reserves by about two-thirds (McLeod 1998a: 923), in November 1997 the authorities moved even further in trying to placate hard-liners in the financial markets by implementing the seemingly tough action of closing down some 16 banks that appeared to be insolvent. Although the owners of small deposits in these banks would still have access to their funds, large deposits would only be repaid in part, if at all, following liquidation of the closed banks' assets. The announcement of this action had an effect precisely opposite to that intended. The banks that had been closed accounted for a trivially small part of the banking sector, but depositors at other banks immediately took fright, reasoning that there were probably many other banks that were insolvent and therefore at risk of closure (McLeod 1998b: 39-40). The immediate consequence was a flight to safety, with a large volume of deposits making their way from private domestic banks to the state and foreign banks, both of which were perceived to be safe by virtue of their respective ownerships.

As a result of the way this was handled by the authorities there were severe inflationary and exchange rate consequences. Some banks suffered a loss of liquidity as a result of the run on their deposits, but this was made good through last resort lending by the central bank, Bank Indonesia (which, by virtue of *not* closing them

along with the others in November, was now obliged to act as though it believed they were solvent). At the same time Bank Indonesia did little to absorb the now considerable excess funds of the state and foreign banks, and so the supply of base money to the system expanded dramatically. This was entirely unnecessary. The central bank could easily have sterilised the monetary impact of operating as lender of last resort by issuing its own securities to the banks with excess funds. Lack of appreciation among the policymakers of the impact of rapid money supply growth on inflation and the exchange rate presumably explains the failure to act along these lines.

Thus central bank policy shifted 180 degrees as it began rapidly to pump liquidity into the system. The conglomerate owners, who were also the owners of the major private sector domestic banks, probably could not believe their luck. At precisely the time they wanted to reduce their exposure to Indonesia they found an enthusiastic ally in Bank Indonesia, which proved more than willing to lend the funds needed to pay off foreign debt and to purchase new assets overseas.

The great escape

The mechanism was quite straightforward. First, a conglomerate bank would make large new rupiah loans to affiliated companies—ignoring both minimum reserve requirements and related party lending limits—which would then use these loans to purchase foreign exchange in the market, but ultimately from the central bank. The latter had quickly had second thoughts about floating the rupiah and was now back in the market trying to prevent the currency from depreciating further, by selling off its reserves. The effect of these transactions was to cause the conglomerate bank's clearing account to be overdrawn, whereupon a plea would be made for 'temporary' liquidity assistance from Bank Indonesia (notwithstanding the fact that the shortfall was the entirely predictable consequence of making large new loans to finance what was, in effect, speculation against the currency). Over a period of several months a very large amount of this liquidity assistance was disbursed—some Rp 145 trillion.¹²

Both the lending to affiliated companies and the failure to maintain positive reserves at the central bank were illegal in terms of the regulations then in existence, but of course banking officials were well accustomed to the franchise rules of the game: namely, that formal regulations were applied or ignored according to what suited

¹² Around US\$17 billion at an exchange rate of Rp 9000/\$. The State Audit Agency was later to report in highly critical fashion of the central bank's actions at this time (Badan Pemeriksa Keuangan 2004). The full report (to the parliament) has never been made public.

the franchisor at the time. In this way Bank Indonesia assisted many of the insider firms, which had grown fat from the private taxes levied on the general public over the previous three decades, to shift their wealth out of an Indonesia that now looked far less hospitable to them—with minimum inconvenience. In the alternative, the owners of these insider firms would have been obliged to sell their Indonesian assets, presumably at a loss, so as to generate the cash that would have allowed them to purchase assets overseas or pay off their foreign borrowings.¹³ This was precisely the fate of foreign portfolio investors wanting to cut their exposure to Indonesia.

Ignoring the political economy background, the straight economic explanation for Indonesia's outlier experience in relation to both inflation and depreciation of its currency is therefore that, when the government and the central bank decided to float the exchange rate—which had served as the nominal anchor for macroeconomic policy for many years—they simply did not understand the implication of this: that a substitute nominal anchor was needed. After a few weeks of confusion the authorities began to try to reassert control by using an interest rate as anchor, but unfortunately they had no idea what an appropriate rate would have been, first raising it, then reducing it in response to the predictable howls of protest from the business community, later to push it up again. The confusion is evident in the frequent portrayal of monetary policy at the time as 'tight' on the basis that interest rates had been increased. Monetary policy was in fact anything but tight: base money virtually doubled in the ten months from September 1997. Until the end of 1997, sales of foreign exchange by Bank Indonesia partially offset the expansionary impact on the money supply of its last resort lending to the private banks, but the scale of such lending was so large as to exceed the rupiah value of foreign exchange purchases, such that (in the absence of adequate offsetting open market operations) the quantity of base money increased rapidly, boosting inflation to levels far higher than in the other crisis countries. From February 1998 BI began to accumulate foreign reserves again, and base money growth continued apace until the middle of the year (McLeod 2003: 309–11).

The currency board proposal

It was not until February 1998 that attention began to be focused on the central bank's expansionary monetary policy as the cause of rupiah depreciation and

¹³ In principle they could also have borrowed against those assets, but in the circumstances no other arm's length lender would have been willing to lend more than a fraction of the amounts provided by Bank Indonesia.

inflation getting out of hand. Professor Steve Hanke, a newly arrived foreign adviser to the president himself, rather than anyone in the economic arms of the bureaucracy or the IMF, quickly drew the president's attention to what was going on. Hanke's advice was, in effect, that Bank Indonesia had utterly failed in its job of maintaining the value of the currency as a consequence of its lack of appreciation for the importance of money supply growth, and that the appropriate solution would be to replace it with a currency board – an essential characteristic of which is that it has no discretion in relation to determining the money supply. But whereas in the past all that was necessary to introduce a new policy was to persuade the president that it would be successful, by now Soeharto had already lost his ability to impose his will on his cabinet and the bureaucracy.¹⁴ Indeed, precisely because the policy had been proposed by his personal adviser, sidestepping not only the central bank and the bureaucracy but also the high priests of crisis management and recovery at the IMF, this was sufficient in the eyes of most to condemn Hanke's policy solution as unrealistic and self-serving on the part of the first family (Davis and Solomon 1998).

What Hanke had proposed reflected what has been argued above: that matters got out of hand because the central bank had abandoned its previous nominal anchor for macroeconomic policy without finding something with which to replace it. Hanke's solution was to return to a fixed nominal exchange rate as the new anchor, in combination with a commitment to 'put the money supply on autopilot', allowing it to be determined by market forces rather than bureaucrats in Bank Indonesia. But the cacophony of voices opposed to the new proposal was so raucous that the president was unnerved and backed away. The loudest voice of all was that of the IMF, which was no doubt deeply embarrassed by the fact that an interloper had exposed its failure either to notice, or to do anything about, the egregious breakdown of monetary policy at the time. The Fund was presumably also dismayed by the prospect of the potential blow to its prestige if Indonesia had accepted Hanke's advice rather than its own. Thus the IMF threatened to withdraw its support if the proposal went ahead, knowing that this would have been extremely unsettling to the financial markets. It is hardly surprising that Soeharto backed down.

From about February 1998 the balance of payments had returned to surplus, largely because the large real devaluation that had occurred strongly favoured net exports,

¹⁴ Arguably, he gave this away the day he allowed his officials to invite the IMF to help Indonesia deal with the crisis, in the misguided belief that a multi-billion dollar loan from the international community was the key to escaping from the crisis.

and also because the economy was heading into deep recession, which had a similar effect. But for whatever reason, Bank Indonesia still failed to engage in open market operations on a scale sufficient to sterilise the monetary impact, and so the money supply continued to rise rapidly – despite the government’s solemn commitment to the IMF to keep base money growth to a low level. Failure to abide by this commitment meant that several more months were lost before monetary policy and inflation began to be brought under control.

Ironically, the avoidable continuation of high inflation was one of the factors that accelerated Soeharto’s demise: if only he had pushed through with Hanke’s advice, perhaps his regime would have survived at least a little longer. Hanke himself has argued that the international community was not unhappy to see a continuation or worsening of circumstances that would make it more difficult for Soeharto to hold on to office. In support of this, he has often quoted the smug observation by the then managing director of the IMF, Michel Camdessus, along the lines that the IMF had created the conditions under which Soeharto felt obliged to step down (Sanger 1999). It is worth noting here that growing domestic opposition to the franchise had been accompanied by growing opposition from overseas, not least because the international community had become well aware that a lot of its financial assistance to Indonesia was ending up in the pockets of the elite. There was a growing awareness, also, of the regime’s repressive nature as a result of episodes such as the Santa Cruz cemetery massacre in East Timor (Joliffe 2001), the banning of *Tempo* (Steele 2005), the brutal murder of labour activist, Marsinah (Fane 1994: 38), and so on. Whether or not the IMF intended to engineer Soeharto’s abdication,¹⁵ that is precisely what happened, although the discussion above suggests that this would have happened in any case, sooner or later, by one mechanism or another.

CONCLUDING COMMENTS

The death of Soeharto in January 2008, almost 10 years after he was forced out of office, precipitated the publication of a vast number of obituaries in Indonesia and

¹⁵ Camdessus denied this, but former US Secretary of State Lawrence Eagleberger has been quoted (*Agence France Presse*, 20 June 1998) as saying: ‘We were fairly clever in that we supported the IMF as it overthrew [Soeharto]. Whether that was a wise way to proceed is another question. I’m not saying Mr Soeharto should have stayed, but I kind of wish he had left on terms other than because the IMF pushed him out.’

around the world. With relatively few exceptions these pointed out both Indonesia's extraordinary economic achievements under Soeharto's leadership, together with the major black marks against his name, in the form of human rights abuses and large scale corruption. In terms of the present paper, the human rights abuses should be interpreted as aspects of Soeharto's determination to maintain his political monopoly by the ruthless deployment of the power of the state against individuals and organisations that dared to oppose his regime. The corruption—the egregious abuse of public power for private profit—should be interpreted partly as the ultimate objective of the franchise and partly as another of the instruments by which the president's political monopoly was able to be maintained. Finally, the economic achievements should be interpreted as the consequence of Soeharto's pursuit of his own, and his family's and cronies', self interest, since the flow of private tax revenues to the regime and its affiliates was enhanced by rapid economic growth.

The model presented here may well find wider application to the case of other countries. Similar *de facto* political monopolies could be argued to exist or to have existed in Singapore and Malaysia, for example. The longevity of the regime established by Lee Kuan Yew presumably owes much to the fact that the virtually unchallenged political power of his and subsequent governments seems to have been used mainly for the benefit of Singapore's population as a whole, rather than for any group of privileged insiders. By contrast, the significant weakening of the regime that had been built up by Mahathir Mohamad in Malaysia in the elections in March 2008 may signal its own unsustainability in the long run. Meanwhile, in a vastly different setting, it is hard to avoid the conclusion that another political monopoly is in the process of creation in Vladimir Putin's Russia, where the general public seems only too eager to embrace as its leader a man who has been able to deliver significant material benefits, largely based on the exploitation of vast natural resources and of the formidable power of the KGB.

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