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Part 4: Session 4

The Case of Indonesia: Why and How Institutions Matter in Indonesia's Episode of Economic Performance

Iwan J. Azis

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Abstract

Prof. Azis began his conference paper by clarifying the meanings attached to each of his key terms. As the "rules of the game in a society," institutions are meant to facilitate human interaction by providing patterns that will regulate society's behavior. Their presence reduces uncertainty by providing a predictable structure to everyday life. Hence, institutional constraints promote some individual behavior and prohibit other behavior. Some institutions are formal (e.g., bank regulation, tax system, accounting rules), others are informal (e.g., codes of conduct, business habits, norms).

While most analyses focus on the former, the latter can be even more important when we try to explain a country's actual economic performance. The other side of institutions is their acceptance, compliance (voluntarily and/or based on market forces) and ultimately enforcement. Rules and regulations may have been well established under the prevailing conditions of a society, but at the same time are rendered ineffective if their acceptance and enforcement is weak.

Two countries may have similar institutions, both formal and informal, but their economic performance can be very different depending on the level of acceptance in practice and/or standards for enforcement. In this respect, enforcement is not only an integral part of the institutional framework, but it may also be one of the most important elements in explaining differences in economic performance.

Organizations, defined as groups of individuals bound together to achieve some objectives, are related to institutions. The relationship between the two can have important implications. Organizations, including the government, can influence institutions, and in turn they can affect the outcome of economic performance.

Prof. Azis then proposed a series of analytical questions to serve as the basis of his study. Why should one be concerned about the role of institutions in "explaining" different economic outcomes? Why is it so important to look at the role of institutions in order to explain the booming economy of East Asia and the devastating performance of the same economies in 1997? Where do a country's institutions originate? He addressed these concerns using the

episodes of Indonesia's economic performance as a case study. Following on from his earlier work, he sought alternatives to these questions when he could not find convincing answers from the list of "usual suspects" for the real causes of the Asian crisis.

Presentation of Arguments

The Indonesian episode can be simply told as a story of the right (macroeconomic) policies, but paired with the wrong institutions. Right up to the outbreak of the crisis, Indonesia consistently scored well on issues such as market liberalization, reform and deregulation, but on institutional issues the country was always ranked lowest.

It was no secret that Indonesia's formal institutions were generally weak. The country's legal system was marred with serious flaws. In almost all affairs, basic and effective checks-and-balances were absent. Even formally installed rules, regulations, and laws were not effective, or weakly enforced in almost all sectors and levels of organization.

Informal institutions and prevailing social norms were equally nonconducive, suffering from the same predicament. When a very high profile business case was at stake, the ultimate decision generally would have to have come from former President Suharto himself or his inner circle. In this sense, he was in practice the only ¯ and most effective ¯ institution in the country.

Even some foreign investors and external partners in joint ventures that operated in Indonesia tended to comply with the prevailing socially suboptimal norm. But in looking for choice domestic partners, savvy multinationals would always prefer to venture with those who had close political connections. Opportunities were limited for local entrepreneurs who were not connected, and hence transaction costs were high unless they too were willing to collaborate with these politically sensitive groups.

The weak enforcement of formal rules and regulations was the most serious flaw in Indonesia's institutional framework. It has prevented transaction costs from declining. For example, the 1988 bank reform allowed the opening of new banks. While allowing some robust investment and economic growth, the fast growing number of banks since then has produced considerable unintended side effects.

Many conglomerates set up banks or multifinance institutions primarily to serve their own projects on sweetheart deals. Despite standard regulatory measures formally imposed by the monetary authorities (e.g., legal lending limits, capital adequacy ratios and so forth), weak enforcement discouraged the development of a healthy banking sector. Indeed, when the contagion-led crisis struck, the weaknesses of the entire financial sector became more prominently revealed.

If Indonesia and the region's institutional factors were so weak, why did the Asian economies manage to grow so strongly and to do so for more than three decades? The business environment during the boom period had been largely based on power (political) connections and personal relations. Maybe these shortcuts were not so serious until the coming of the 1990s, but the incidence and egregiousness of such practices increased markedly during the mid-1990s, coinciding with the trend of massive capital inflows from outsiders not understanding or tolerating such local practices. When the contagion struck, this combination proved fatal.

Government influence stayed pervasive even after the major reform in the 1980s. For instance, within a privatization scheme, the decision on how the process should operate, and to whom the entity was to be sold was either not made transparent or rested eventually on the government's decision. In the process, the woeful practice of corruption, cronyism and nepotism (CCN) became widespread.

Nevertheless, even in the absence of fair and transparent institutions, the process of privatization actually took place (and was effective, if not wholly fair), allowing more resources to be tapped and generating higher output growth.

If Indonesia and the region's institutional factors were so weak, why did Asian economies manage to grow so strongly and did so for more than three decades?

Similarly, in the agricultural sector, for example, the green revolution, being heavily physical, chemical and biologically-based, would not have achieved its desired goals without enormous subsidies and credits from the government. This fortunately led to an important success for Indonesia in achieving rice self-sufficiency. In the more liberalized manufacturing sector, government influence was also pervasive even after the major reform in the 1980s.

The next important source supporting robust economic performance was massive capital inflows. As a result of widespread and often unrealistic optimism over the region's future growth and the celebrated label of "East Asian Miracle," domestic and foreign private investors greatly expanded their activities from the early 1990s. The high domestic interest rate did not dampen their enthusiasm, largely because foreign loans were easily obtained at a relatively low rate. The label "miracle" also seems to have swayed lenders and the international financial community to the extent that they recklessly made many high-risk loans.

But why were the pressures to improve institutional frameworks not so strong? When the economy and the business sector flourished, there was no urgent need to alter the system. Human nature dictates that as long as growth was delivering benefits to practically everyone, CCN could be tolerated as annoying but not fatal. Consequently, the middle class/student demand for improved institutions did not yet exist.

While institutional factors have never taken a center stage in the explanation of Indonesia's economic success, the question of what institutions to create is more (or at least equally) important than the question of what policies to adopt in order to facilitate the implementation and sustainability of desirable economic policies.

Data produced by International Country Risk Guide on corruption discloses that the relative position of Indonesia was worst among East Asian countries. With respect to the judicial system, Indonesia's position was also extremely weak, with only Columbia in a comparable position. Worse still, judging from the trend of the indices, the fall in the quality of Indonesia's judiciary system over the period of 1990-1997 was dramatic, i.e., from 6 to 2.

From a comparative study using three Indonesian telecom firms, it is revealed that (i) the degree of a firm's success depends on the extent to which it is not involved in CCN-related business (e.g. P.T Indosat performs better since it has less alleged crony business deals compared to P.T Telkom), and the company with less CCN tends to invest and improve its services in a transparent manner; (ii) when the share listing is done on a foreign market, such as the case with P.T. Indosat again, the performance tends to be better due to stricter reporting and disclosure requirements in the foreign markets; and finally (iii) when the CCN element is heavy, as the case in Bimantara, the expenditures far exceed the funds raised from the stock market, and specialization is no longer the rule. Consequently, the debt exposure tends to be high and is invariably used for risky business.

There is also a constant concern about the cost of dealing with politicallysusceptible business, e.g. the possibility that the company would capriciously lose its monopolies and privileges; thus a CCN company's growth cannot be sustained when the political pendulum changes. Finally, returning to the causality between institutions, transaction costs and "economic performance," Prof. Azis believed that in generating an exante scenario, the endogenously determined "economic performance" should ideally not be restricted to economic indicators, but should include environmental-related and distributive subjects.

It is not difficult to argue that sustainability of growth is largely influenced by public support. An absence of the latter ¯ which is more likely to occur if distribution of income is skewed ¯ may inhibit any policy to support a sustained growth path. Similarly, growth sustainability can easily be hindered if the degradation of environmental resources is uncontrolled. In short, it appears that, however distasteful, the one-person institution with strong enforcement worked surprisingly well until 1995. How could such a weak institutional infrastructure have sustained three decades of continued growth contrary to conventional economic predictions?

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The Case of the People's Republic of China: The Institutional Foundations of PRC's Market Transition

Yingyi Qian

Abstract

This paper sought to account properly for PRC's two decades of market transition by examining its institutional foundations. The journey of transition was analyzed as a two-stage process. In the first stage (1979-93), the system was reformed to unleash the standard forces of incentives, hard budget constraints, and competition. The underlying institutional forms and mechanisms, however, were far from conventional: reforming government through regional decentralization; entry and expansion of non-state (mostly local government) enterprises; financial stability through "financial dualism"; and a dual-track approach to market liberalization.

In the second stage, PRC aimed to build a rule-based market system incorporating international best practice institutions but eventually proceeded in its own distinctive manner. Major progress was made in the first five years (1994-98) on the unification of exchange rates and convertibility of the current account; the overhaul of the tax and fiscal systems; reorganization of the central bank; downsizing of the government bureaucracy; and privatization and restructuring of stateowned enterprises (SOEs). To complete its transition to markets, PRC still faces serious challenges, especially in transforming its financial system and SOEs and in establishing the rule of law.

The paper concluded by reflecting on the economics of reform and institutional change from the PRC experience. The main lesson learned was that considerable growth is possible with sensible but not perfect institutions, and that some unconventional "transitional institutions" can be more effective than the best practice institutions for a period of time because of the 'secondbest' principle. Specific lessons include: incentives, hard budget constraints, and competition should apply not only to firms but also to governments; reforms can be implemented without creating many or big losers; and successful reforms require appropriate, but not necessarily optimal, sequencing.

Presentation of Arguments

PRC shares many East Asian characteristics such as a high growth rate and savings, but it is different from others, except Viet Nam, in that it is a transition economy. The fact that PRC faced the double problem of transition and development presented a bigger challenge, and its singular performance appears more impressive compared with other transition economies. More study needs to be done to discern all the lessons from this unique work-inprogress.

We can make a start by analyzing the journey of PRC's transition to markets as a two-stage process. In the first stage (1979 to 1993), the old system was reformed in an incremental way to improve incentives, harden the budget, and create competition. In this stage, PRC did not have a clear idea of what the new system would be like and thus proceeded as though "crossing the river by touching stones," and growth occurred mostly outside the public sector.

In the second stage (1994 to 1998), PRC made systematic efforts to establish a rule-based market system both simultaneously and sequentially. These two stages can be divided for analytical framework purposes, but were not consciously designed by the government.

In the beginning of the reform period, reformists did not think of the power of the market, let alone private ownership: they were just reacting to failed practices. Contrary to many scholars' beliefs, PRC did not start reform with well-sequenced plans. In fact, it began SOE reforms, special economic zones and the contracting system, with a great deal of trial and error. The non-state sector and township and village enterprises (TVEs) proved to be an engine of growth for the market mechanism..

Considerable growth is possible with sensible but not perfect institutions, and some unconventional 'transitional institutions' can be more effective than best practice institutions for a period of time because of 'second-best' principles.

For the first stage, Prof. Qian described four pillars of this institutional change for reforming the government, firms, the financial system, and markets, respectively.

The industrial output share of state-owned enterprises (SOEs) in 1993 had decreased to 43% while the share of non-state enterprises increased from 22% to 57%. The non-state sector in PRC is not the same as the private sector, and more than 80 percent are controlled by local (township) governments, given the underdevelopment of institutions and financial markets.

Government tax revenue collection sharply declined from 31% in 1978 to 13% in 1993. However, at the same time there was tremendous financial deepening; that is, a substantial increase of household bank deposits. The government lost fiscal revenue, but, on the other hand, PRC gained from implicit taxes on deposits. Most people criticize the banking system of PRC, but it has played an important role in mobilizing savings, comprising 40% of GDP, and the government has taken advantage of these quasi-fiscal revenues.

This is in sharp contrast to financial system collapse in Russia and parts of Eastern Europe. The market was liberalized at the margin while planned prices and quotas were maintained without creating significant losses.

In this first period, PRC was successful in economic growth and institutional reform. But this was acheived without complete market liberalization, privatization, secure property rights, democracy or transparency. The main lesson is that some transitional institutions can be more effective than best practice institutions for a certain period of time.

The policy measures adopted were mostly of the decentralization of the decision-making power together with the material incentives (in Chinese, fangquan rangli), and they were not intended to be in line with marketization, but to strengthen the road to "socialist modernization." By the end of 1993, despite all these positive successes, many problems appeared such as sluggish reforms, inflation, fragile financial system, lack of market system, widespread corruption and increasing inequality.

In November 1993, the content of the 'socialist market economy' became clearer, replacing the planning system with a modern market system entirely. In 1997, even private ownership was elevated to an important component of the economy, and finally enshrined in the constitution by March 1999.

PRC was successful in economic growth and institutional reform, but this was achieved without complete market liberalization, privatization and secure property rights.

The major achievements in the 1994 to 1998 period were as follows:

- Unification of foreign exchange rates and convertibility of the current account were successful.
- Local and central tax became separate, and a system and institution is in place. The new budget law mandates tight control and no deficits are allowed.
- Monetary reform has been successful. In 1998, the central bank replaced its 30 provincial branches with 9 cross-province regional branches as in the U.S. system, and this reform minimized the local governments' influence on monetary policies. However, banking reform has made very limited progress. The privatization of small SOEs was commencing, but that of larger ones was disappointing.

Both the ideological shift and significant progress made so far have demonstrated that PRC's early reform was somehow able to build constituencies and momentum for further reform, rather than create more obstacles to block it.

Prof. Qian identified the four major challenges that still lay ahead for completing PRC's transition:

- Promoting pure private small and medium enterprises will create a new engine of growth, replacing the role of TVEs. In Zhejiang province in 1998, private industry recorded more than 50% of output for the first time in PRC. But, Zhejiang province is rather exceptional since it had very few SOEs in the past due to geographic proximity to Taipei,China and experienced high growth during the past decades.
- In September 1999, decisions opened some new opportunities by limiting the scope of the state sector over national security, natural monopoly, public goods, and high-tech industries.
- Undue emphasis has been put on the problem of non-performing loans, which make up 20 percent of GDP. However, this should be regarded as a government debt problem, which is ultimately manageable. The real issue is that poor practices are still continuing in the state banks. So, reform of banks is key through a variety of means such as public issues, diversification of ownership and introduction of foreign competition. Among the recent WTO entry-condition agreements, financial liberalization has the most far-reaching consequences in that once free entry of banks is allowed, government will ultimately lose control of financial systems.
- Finally, the firm establishment of the rule of law in the hearts and minds of the elite and general populace still remains the most difficult task, since PRC retains a communist system.

One last puzzle is why state-owned enterprises (SOEs) suffer from many problems, while township and village enterprises (TVEs), which are monitored by local governments, have been generally successful? Concepts and functions of government and inclusion are very different between central government and township and village government levels, and this might partly explain the divergence.

In summary, this study has squarely challenged the conventional wisdom of whether there really is a universal set of necessary and sufficient conditions for any transition economy: namely, stabilization, liberalization, privatization and democratization. Clearly, these four conditions are not yet well implemented in PRC, but still there is growth of about 10%. Instead, we can resolve this puzzle by inventing a new concept of transitional institutions, which was very much in line with the thesis on the continuing utility of a customary economy.

Commentary and Discussion

Shigeru Ishikawa

Shigeru Ishikawa is Professor Emeritus at Hitotsubashi University and Aoyama Gakuin University and an Honorary Fellow at the University of London. In 1998 Prof. Ishikawa was appointed a member of the Japan Academy. During the course of a distinguished academic career, he has been a research fellow at Harvard and a visiting professor at the School of Oriental and African Studies, University of London and Josai University. He has published major research in the fields of capital formation, economic development and labor absorption.

The Case of Indonesia: "One-man Institution"

Prof. Ishikawa was persuaded by the account offered by Prof. Azis of Indonesian informal institutions, which highlighted the widespread practice of corruption, cronyism and nepotism (in short, CCN).

In this connection, Prof. Ishikawa raised two questions:

- Was the CCN practice in Indonesia connected with the well-known strong tradition of village community, which evidently survived in rural Indonesia until recent years, and if so, how?
- How can one compare Indonesian cronyism and other traditional personal relations with the more or less similar practices and traditions that can be observed in neighboring Asian countries?

This question was suggested by Prof. Azis's description of the former President Suharto-centered institution that provided a chance to consider the component of the institutional aspect of the development problem relating to "customary economy" and "customary politics" (or in one word, customary institutions) in more general terms.

In economies where the framework of a sophisticated market economy remains underdeveloped, the customary economy with local norms and practices tends to play a significant role to fill the gap of incomplete resource allocation. This supplementary role of the customary economy was greater in the more underdeveloped market economies, given the role of cultural tradition which varies among countries. A similar thing might be said about customary politics. It should also be noted that both customary economy and politics would have positive as well as negative effects on economic development.

Finally, there is recently a tendency to stress the aspect of the customary institutions which, as part of social and organizational capital, play a role of reducing the transaction costs and also making the transition process for change smoother. We have to remember, however, that customary institutions will be destroyed sooner or later in the process of economic and political development, and that, in the meantime, they are likely to bring about cases with reverse effects. Moreover, we have yet to make a really comprehensive and systematic study on the role and effects of customary institutions.

The Case of PRC: "Crossing the River by Jumping on Stones"

An ex-post interpretation could be useful to analytical work for building a long-run theory of system changes. But for derivation of policy suggestions, ex-ante analysis seemed essential. In the past several years, the discussant himself had engaged in a policy-oriented study on the economic system reform in PRC in this sense. His particular concern was to use the derived lessons from PRC for application to the transition process underway in Viet Nam.

According to Prof. Ishikawa, in order to make an ex-ante study, it is useful to map the necessary steps for deriving a marketization scenario for the earlier reform period. The scenario is equivalent to a "strategy," indicating the goal of the system reform, the process to reach it and their dating. Production tasks should always be specified, as the effort for systemic or institutional reform are mostly premised on specific production tasks, especially in the short-run.

In the earlier stages of reform, effort is mostly through a trial-and-error process, groping for more effective systems for solving the production tasks. The same process would be repeated, and the individual scenario becomes more and more complete.

In economies where the framework of a sophisticated market economy remains underdeveloped, the customary economy tends to play a significant role to fill the gap of incomplete resource allocation.

Applying this scenerio to the PRC reality, the production task at the start of the period of economic reform in 1978 was, in the mind of the leaders, mainly to recover from the economic loss caused by the "Lost Decade" of the Cultural Revolution (1966-1976) and its resulting stagnation. The policy measures adopted were mostly of the "decentralization of the decision-making power together with the material incentives" (in Chinese, known as fangquan rangli), and they were not intended to be in line with marketization, but to strengthen the road to "socialist modernization."

This trial-and-error process encountered its first serious difficulty in 1984, when it resulted in the first case of excess-demand type inflation in PRC, and thereafter government gradually felt the necessity to introduce the market-economy type mechanism of macroeconomic management. On the real side sectors also, agricultural and manufacturing production increased considerably, solving the first generation problems. But then, the secondgeneration problems began to emerge in various forms.

A number of crucial policy implications of this ex-ante study may now be noted. First, it may take many years to reach the first-generation scenario for transitional developing economies since many of those concerned go through a normal trial-and-error period. Consequently, donor governments and international aid organizations might need to be more patient and understanding about this process of indigenous trial-and-error.

Meanwhile, cooperation with developing economy-type transition countries might be based upon practical policy dialogues in association with assistance to solve sectoral production tasks. The IFIs stance of cooperation with PRC in the 1980s was commendable, but donors could have been more cautious considering such transitional economies were recipients of structural adjustment lending.

On the other hand, the recipient country might try to formulate a scenario and publicize it as early as possible; both internally as a guide to all those concerned, and externally as a clear indication of the country's path directed to the goal of the market economy.

Open Discussion

Donor governments and international aid organizations need to be more patient and understanding about the process of indigenous trial-and-error.

It was considered how the Ishikawa framework, particularly the trial-anderror (or pragmatism and experimentation) stage, might be applied to corporate governance reform in Indonesia and other economies. Until the mid-90s, economic technocrats had been able to bring successful growth to Indonesia and other places. But technocrats found that they could not deal with a capital-account crisis since this is more of a micro and corporate-governance issue rather than macro and current account-crisis issue. As such, this was a new crisis that would have to be addressed by the reform of corporate governance.

Here, an intriguing point is the precise linkage between micro and macro issues and how they may be approached. For example, corporate debt is related to a number of indicators, including ownership. And so a high debtequity ratio must be ultimately reflected in a country's macro indicators, e.g. short-term debt ratio. All these contribute towards the vulnerability of a country to shocks when they come.

In closing, the dialogue participants recognized that the interaction between formal and informal institutions and transition policy is very important. The past successes in Indonesia were most likely due to strong implementation under a "one-person institution," and without former President Suharto's consent, the right macro policies of the economic technocrats could never have been implemented. However, the identified limitations of this one-person institution also resulted in a more severe crisis when it finally came.

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