

**The Pros and Cons of Corruption on Firm Performance:
A Micro-level Study of Businesses in Indonesia**

by

Karuna Murdaya

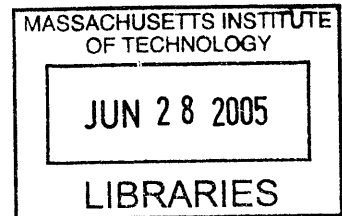
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Abstract

Over the past 10 years, different international organization and NGO's have given birth to a whole host of different anti corruption programs in response to the recent "endemic" of corruption which is seen to plague developing countries in the world today. Behind the formation of these new programs is a clear international consensus that corruption, though not a new phenomenon, is one of the main reasons for economic stagnation in much of the developing world. The reasons for this "sudden" realization among the development community are both empirical and political. Empirically, new quantitative studies on corruption have shown that corruption is negatively correlated with GDP growth, foreign direct investment, human development, and the list goes on. Conversely, more corruption, according to some anti corruption actors, kills babies.

In light of the main stream literature, this paper seeks to examines the connection between corruption and firm performance in Indonesia, a country which by most accounts is historically one of the most corrupt in Asia, yet has sustained one of highest long term GDP growth rates in the world for almost 30 years. This paper assumes that, rather than being what the World Bank calls a "cancer on development", this paper argues that corruption is a cultural manifestation, which underlies the business processes involved in economic development. Corruption may be damaging or helpful for development, though any outcome is context specific. By analyzing more closely the current and historical dynamics between state and private agents, this paper explains how corruption, long term economic development and efficient business practices are not mutually exclusive.

Acknowledgments

This thesis would not have been possible without the support and inspiration of my parents whose tireless efforts in pursuing business and social work in challenging areas inspired me to study development in the first place.

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Table of Contents

Introduction	9
Question and Hypothesis	9
Methodology	11
Limitations of Study	13
Chapter Outline	14
Chapter 1: Definitions and Literature Review	16
Defining Corruption	16
Government Involvement	20
Legal and Political Context	22
Social Norms	25
Summary of Ideas thus Far	27
Literature Review	29
Old Economics (Pre 1990's)	30
Economics (non Washington consensus)	32
Economics (Washington consensus)	34
Chapter 2: The Role of Anti-Corruption	38
International Approaches to Anti Corruption	42
The Roots of Modern Anticorruption, the FCPA	45
The United Nations	49
The World Bank and IMF	51
The Empirical Analysis on Corruption	55
Corruption and Foreign Competitive Advantage	55
Corruption and Development	57
Conclusion	62
Chapter 3: The Cultural Context of Corruption in Indonesia	67
A Brief History of Corruption in Indonesia	68

Pre-colonial Java	68
The Period under the Dutch	70
The Revolution and the Period under Soekarno	72
Soeharto and the New Order	75
The Post Soeharto Period 1998-Present	78
Reflections on Corruption in Practice	79
Corruption and Property Rights	80
Relatively New Issues with Corruption	87
Taxes	88
The Judicial System	93
Chapter 4: Final Conclusions	97
Appendix: Summary of the Research Data	102
Review of the Methodology	102
General Disclaimer and Limitations of the Study	102
A General Summary from the Interviews	104
A Review of Public Private Corruption	107
Preferential Treatment	109
Bribery, Gifts, and “Good human Relations”	110
Conclusion in brief	113
References	XXX

Introduction

Question and Hypothesis

There has been a strong awareness in the academic and policy-making literature over the past 10-years that corruption is one of the biggest challenges facing developing countries and economic development. Accompanying this awareness is a strong consensus between large international organizations such as the World Bank, OECD, UN and governments within the developed and developing world that the 'recent' epidemic of corruption threatens to derail development and must be stopped. Curbing corruption in developing countries, a responsibility the World Bank, UN, OECD or most large development institutions never championed prior to 10 years ago, has been pushed to the forefront of most development agendas. Many of their policy arguments for anti corruption have been justified by recent economic literature which empirically shows a correlation between corruption and the many woes of the third world, including but not limited to: low foreign investment, low economic growth rates, lower HDI, and more environmental degradation. In short, the message is that corruption is bad for development. The World Bank institute, a department of the World Bank in charge of giving economic advice on poverty alleviation have even asserted that corruption and strong governance cannot co-exist because corruption always subverts the funds necessary for good governance as well as undermines the legitimacy and effectiveness of governments in corrupt countries.

However, historical evidence shows that the connection between corruption and impeded development cannot be so clearly drawn. By modern ethical standards, the nature of European colonial empires and American Industrialization through much of the

18th-20th century are considered very corrupt, yet corruption did not halt their development. In their cases, patronage and personal payments were the accepted form of payments, which drove much of the government and economy. Similarly, in the years following World War 2, corruption was ‘endemic’ in the many non democratic military bureaucracies in Asia, namely Korea, Indonesia, and Thailand, yet those countries for decades sustained the fastest long term economic growth rates the world had ever seen. Furthermore there are clearly a multitude of poor countries, which are perceived as both corrupt and honest as well. The issue is a complex one, but as far as corruption is an issue in development, there exists an opportunity where synergies can exist between a country’s conditions and controlled corruption, which can lead to development instead of mere predation by the government.

The issues concerning the effects of corrupting are highly context specific, where both the physical and cultural conditions ultimately determine the outcome. For this paper, I engage the debate on corruption and development by asking how the presence of corruption affects private firm performance in Indonesia, the “most corrupt country in Asia”¹. It is the intent of this paper to study at the micro level, specifically how corruption, as it appears between the public and private sector, enters the standard business practice of individual firms. This study reviews firms in different industries, and asks how a firm’s involvement in corrupt practices gives benefits or costs to business practice, what those benefits and costs are (financially or otherwise), and methodologically tries to diagram where potential synergies exist. I originally

¹ This is according to a recent survey of foreign businessmen. It can be found at http://www.finance24.com/articles/economy/display_article.asp?ArticleID=1518-25_1673012

hypothesized that participating in corrupt activities in Indonesia was a necessity for all firms to just stay in business, where corruption could be a large or small transactions cost to development. But after doing the research, I found the answer to be much more nuanced, with corruption playing a much less prominent role in terms of the actual monetary cost to businesses in most sectors, but serving a much more important cultural function as a medium by which to conduct businesses, seek opportunities, or simply lose money. The debate thus changed from a question of simple costs and benefits, to understanding how the underlying dynamics of firm and government interactions create opportunities for success or failure and the integral part corruption plays in all of this.

I chose to focus on the performance of large private firms because of their significance, to a country's economic growth, at least in the case of Indonesia and many other South East Asian nations. In Indonesia's case, the top 20 private conglomerate groups account for more than 25% of the nation's GDP. The majority of my interviews come from firms within these large business groups. Secondly, I chose Indonesia for this research because of my personal connections with many individuals in different industries who were willing to talk to me about the workings of their respective industries, and also because, as an "endemically corrupt" country, all of these industries were likely (and in hindsight, do) have to or prefer to constantly undertake corrupt interactions in standard business operations.

Methodology

This paper was researched by interviewing senior management and financial staff at many firms in different industries about their business practices, how corruption entered their business practices, asking very generally what benefits or costs it provided them, and how and how much corruption ultimately affected their bottom line, as well as the implications of corruption for future business opportunities. Additional questions were also asked to get some background context, including, the differences between business practices now and when the former president was in power (pre 1998).

The firms asked were for the most part large, and representative of their respective industries, which ranged from manufacturing to services and hospitality. Firms interviewed were both private and public, and either local, local-foreign joint venture, or foreign. The interviews ask how corruption was pertinent to each individual industry, and list where corruption enters into the business practice (e.g. in the procurement of industry specific licenses, tenders, and the like) and see how important corruption is to business profitability or success. I also asked what specific actions firms took in order to get what they needed, and how common these practices were.

Secondly, the study asks in what areas corruption affects all industries in more or less the same way, regardless of industry orientation. Notable common examples of these are: taxes and legal disputes. These were the concerns most popularly cited by businesses as being the biggest causes of business volatility due to corruption. I discuss the dynamics of the relationships and incentives of the players involved in transactions with these agencies, and common private sector practices used in working with them. The purpose of this section is to gain a more hands on understanding of what practices

take place in a “corrupt” environment, and through understanding the specifics, better assess their implications on business practice as well as success.

Limitations of the study

This research seeks to primarily to study the effects of corruption on the methodology of business practice, and not the aggregate effects of those successes and failures on economic development as a whole. As such this paper assesses only direct firm performance, and not necessarily the positive or negative externalities associated with any firm’s actions. While a firm may be profiting from corruption, there is no doubt that in most cases someone else is suffering. The net pros and cons on society from corruption as a whole will not be as thoroughly addressed in this paper as the firm specific dynamics. Therefore, this paper emphasizes the behavioral and functional effect of corruption on the firms being discussed. Furthermore, it is not recommended that the findings of this research be conclusively expanded to serve as a completely accurate proxy for economic development for the whole of society. Finally, though the findings of this study discuss international cases of corruption, this study makes no claim to the applicability of the findings for Indonesia outside of its national borders.

Secondly, on another note, this study heavily focuses on the point of view of private firms, and not on the government. For personal reasons of liability, I was restricted from interviewing certain relevant government agencies for their views on corruption. All government information I have gained was from the published literature, interviews with the private sector, and from my own personal experiences coming from a very politically involved family in Indonesia.

Introduction and Chapter Outline

Before going deeper into the topic, it is important to define the term corruption as it is used in this paper. Corruption is defined simply by the UN's Global Program against Corruption and World Bank as the "abuse of power for private gain". This definition is very general, as it does not specify the forms corruption can take as well as the players involved. Most studies on corruption define it as public-private corruption, where a private bribe is exchanged for public goods. But corruption can occur wholly within the public sector without private involvement in the form of misappropriation of budgets or foreign aid funds. Or corruption can take the form of purely private sector corruption, which can take the form of anti social behavior such as price collusion within monopolistic or oligopolist firm contexts, where a firm or group of firms distort the supply of a good in the market to artificially drive up prices or other unsocial behavior.

Understanding what form of corruption is taking place is important because the ultimate economic and market effects of corruption are determined by the specifics. But even within the limited confines defining public-private corruption, because of the controversial nature of the act, corruption is still a multi faceted and nebulous concept. This is why I devote the first section of Chapter 1, to outlining the difficulties and assumptions inherent in defining corruption, as well as discuss how it will be defined in this analysis. This is of particular importance because there does not exist a single universal definition of corruption. Different societies have different legal statutes and social and cultural contexts which define ethical or moral behavior, and from that, different notions of what constitute corruption.

After addressing the issues of what constitutes corruption, the latter portion of Chapter 1 reviews the literature concerning the effects of corruption on private business performance and development in general. This review will layout the theoretical basis of the discussions for the rest of the paper, especially Chapter 3, which discusses how the theory applies to the historical, cultural and institutional context of Indonesia.

In addition to the effects of corruption on development, Chapter 2 discusses the policy reactions to corruption and development. It questions the effectiveness of current anti corruption policies, both international and local, and the effects of such policies on economic development. This chapter highlights some of the assumptions underlying anti corruption policy, and assess how they are or are not realistic in understanding and dealing with corruption.

Chapter 3 outlines the historical and political conditions in Indonesia and outlines how corruption overlaps with the culture and local business practices. It describes how the historical patterns of corruption in Indonesia have more or less passed over from ancient to modern times, and how corrupt behavior was an integral part of Indonesia's economic growth process since the 1960's. The discussion of the history and practices draws on the theoretical literature described in Chapter 1, and informs the discussion of the findings in the conclusion and appendix. The latter portion of Chapter 3 describes how this history has influenced the modern tax and legal system in Indonesia.

Chapter 4 summarizes the main findings and themes in this paper. It includes a discussion about the pragmatic effects of corruption, and readdresses the original question posed in chapter one, what is the definition of corruption, considers issues of morality, and argues why anti-corruption should not be anything different from

standard acceptable business practices. It will end with alternative solutions and a strategy to approach to anti-corruption.

Finally, the appendix outlines the findings of the research gained through interviews. It provides a summary of interview data and highlight key firm level dynamics between public and private actors within different industries to explain more specifically the pros and cons of corruption in actual business practice.

Chapter 1

Definitions and Literature Review

This Chapter explores the difficulties inherent in creating a single definition of corruption. The second half of this chapter then reviews the literature on corruption and its effects on development.

Corruption and anti-corruption are catch phrases in the development arena, with many individuals and organizations blaming it for the woes of the developing world. The World Bank has even put curbing corruption as one of its top development priorities saying that curbing corruption is a necessary pre-requisite for the development of most countries. Before accepting these findings at face value and associating corruption as the cause of the world's ills, it is important to understand what actually constitutes corruption. The first half of this chapter highlight elements commonly associated with corruption in order to try to define how corruption will be analyzed for the rest of this paper. The latter half of this chapter reviews the literature on the effects of corruption on development and firm performance.

Chapter 1 Part 1: Defining Corruption

Pranab Bardhan, an economist at UC Berkeley briefly and eloquently describes corruption as: "...the use of a public office for private gains, where an official (the agent) entrusted with carrying out a task by the public (the principal) engages in some sort of malfeasance for private enrichment which is difficult to monitor for the principal"². The World Bank defines corruption even more succinctly as "the abuse of public office for private gain". Both of these definitions highlight some elements which define corruption:

² Bardhan, corruption and Development a Review of Issues, Journal of Economic Literature Vol. XXXV, 1321

illegality, a hidden nature, abuse of government power and a violation of an expected social norm.

But there are examples of things which do not fit all, or even any of these categories, which may still comprise what many may consider corrupt behavior. For example, a private lobby for special interest groups can sway a congress to enact legislation which is damaging to a majority of the populace for the express enrichment of a handful of private business concerns and politicians. An example of this commonly seen in the United States is the lowering of environmental standards for the benefit of a small constituency (e.g. low tech steel mills) at the expense of a larger less organized population (e.g. down stream residents). Though probably unethical, this is completely legal in most developed democracies and does not possess any of the features associated with corruption mentioned above even though it has a very similar end result. On the other hand, in a country which is not democratic or has very strict lobbying laws, the same act could be considered very corrupt.

This example is meant to show that what defines corruption is not universal, but depends on the local social, legal, and cultural context in which the transaction occurs. Many things can be considered corrupt depending on the context, and those same things can be considered not corrupt in another. Outlined below are examples highlighting the ambiguities inherent in defining and assessing corruption, as well as a clarification on how corruption will be assessed in the rest of this paper.

Government Involvement

One notable trend of most corruption literature is that it mostly addresses public-private or purely public sector corruption. For clarification purposes though, government involvement may not be necessary for corruption to take place. An example of this can take place in an oligopoly where a group of private firms can get together and fix prices artificially high for a specific good to create rent profits to the detriment of society.

Another common example can be seen in the bidding process for development projects. Normally, kickbacks (i.e. the use of bribes to bypass a competitive bidding process) are associated with large public projects. But within the context of large private tenders, individuals wholly within the private sector can conspire to receive kickback, as seen in the case between a private developers and private contractors. Here, the actions taking place are very similar to the public case, except that the party offering the tender is private. Depending on the definition of corruption being used, this may be construed as corruption, or lacking clear direct government involvement, it may not.

Public-private corruption is most commonly what is being referred to in the literature when someone mentions corruption, and is the main type of corruption this paper focuses on. For clarification, generally this is when government agents either through coercion or cooperation with private agents enrich themselves at the expense of others. But, in discussing public private corruption and its effects on development, just as important as government involvement in corruption, is the nature of the relationship between the public and private actors in the relationship. For the purposes of this argument, I arbitrarily identify public-private corruption as falling into two general

categories. The first form of public-private corruption I call generalizable or market, and the other is case specific.

Market corruption is where the costs of corruption is bore more or less similarly by firms and individuals within a given industry or country. In it, transactions with the government are for the most part, impersonal. An example of this is in the scenario where government offices function as the sole providers to given goods and services for which all individuals or firms must pay bribes in order to access, such as import and export licenses or building and development permits. This kind of corruption is generally seen as an additional transaction cost in much of the economic literature to development with few significant benefits for the private side.

On the other side there is case specific corruption, where specific firms cooperate with government agencies informally for under the table financing or operational purposes. A firm's access to such collaborative corruption is determined by kinship, ethnicity, political affiliation and ultimately trust. A common example of this type of corruption in Indonesia mentioned to me in an interview involves the marking up of official prices. This is when a private firm working on a government funded project, at the request of a government official marks up the cost of a project. Afterwards, the firm splits the difference between the stated cost (what the firm receives for construction) and the actual cost of construction with the government agent (or agency. Another common example of this would be when the government is taken on as an equity partner in private developments in exchange for more access to necessary licenses, government protection, or even insider information. Case specific corruption for the most part requires a great

deal of trust and collaboration, but firms who partake in such transactions get windfall profits. Very bluntly put, it's good for the bottom line.

But in reality, the division between the two categories, and their associated effects are rarely so clean cut. In the case of market corruption, development firm will form a relationship with the city planning office it goes to for licenses every time it develops, and can get insider information in the future, or assistance in maneuvering other parts of the bureaucracy. Similarly, a politician collaborating illicitly with a private firm may still try to extract money from and squeeze his private partner as much as possible. A firm's access to illicit government interaction, or even legal government assistance, depends on the relationship between the individuals involved. This paper will further discuss how the relationship determines firm performance and access in the research findings in the appendix.

Finally, just for clarification purposes, corruption can exist in the purely public sector. This would be like a government agent or agency coordinating with other elements of the government to embezzle funds. Or it could be a government coercing the private sector to submit to unjust laws for the government's benefit (e.g. unjustifiably high tariffs which serve no purpose but to enrich government agencies, or legally enforcing inefficient and unaccountable government monopolies, etc). The variations are endless. For the purposes of this paper, when I say corruption, I am generally not addressing public only corruption.

Legal and Political Context

In assessing the effects of corruption on firm development, it is important to highlight the legal and political context in which corruption thrives. It is important to

note that corruption thrives in conditions where it is either absolutely necessary or where corrupt transactions can ensure superior benefits to those conducted in legal channels. If the legal system is burdensome or repressive, bribes or patronage may be a preferable or necessary alternative for firms to get what they want. In a more accommodating political or legal context, firms would probably prefer to use formal channels to achieve the same end.

But, as stated above in the example of private firms lobbying for gains at the expense of society, blatantly self serving acts may not be deemed as illegal. Corruption is often just a manifestation of similar actions which could have occurred legitimately in a different legal or governmental context. Legal pressure lobbies function to change legislation in democracies much in the same manner as most bribes to politicians and bureaucrats in dictatorships.

The function corruption serves for firms may be purely rent seeking and detrimental to society, or merely an alternative form of achieving something which is not normally permitted under the existing government or legal system. For example, in the case of non-democratic developing countries where people don't have a say in the creation of laws which affect them, James C Scott points out:

“A sizable number of individual, and occasionally group, demands in less developed nations reach the political system, not before the laws are passed, but rather at the enforcement stage. Influence before legislation is passed is generally called ‘pressure group politics’ and receives great attention from political scientists; and influence at the enforcement stage often involves ‘corruption’ and has seldom been treated as an alternative means of articulation, **which in fact it is**”³

Another example he cites similar to the case of Indonesia is drawn from a comparison between similar systems of political influence in Thailand versus Japan. In

2) See Scott 1969

the case of Thailand during the 60's when it was under a military bureaucracy and the business elite were largely Chinese (as they still are today in both Thailand and many other South East Asian countries including Indonesia). The military government was Thai and did not grant ethnic Chinese access to formal positions of authority. In this case, in order to protect their interests, members of the Chinese business elite established stable relationships with individual clique leaders in the Thai military and bureaucracy. This practice enriched the Thai government officials involved and was considered very illegal, and by most definitions falls under the category of corruption.

Japan offers an 'uncorrupt' but similar scenario. In the 1960's while the Liberal Democratic Party was reigning supreme as it has since the end of WW2, instead of individuals firms making associations and agreements with people in the government, Japanese businessmen worked collectively through 'peak associations' which collected proportional shares of member firm's profits and passed them off to factions within the LDP which had interests in furthering their interests. The funds they provided greatly influenced which faction within the LDP would be elected and was able to successfully push through legislature. This practice personally enriched the politicians involved through greater campaign war chests afterwards. This practice was perfectly legal, and would be difficult, under the legal sense, to be called corrupt despite the fact that both practices involved similar motivations, processes and outcomes⁴.

Given that one country's corruption is another's form of accepted legal government, it is one of the foci of this paper to discuss what role 'corruption' serves within Indonesia's political, legal and social context in order to better gauge its effects on

⁴ On a side note, the Liberal Democrats were kicked out in 1993 on account of corruption scandals. This goes to show that you can't stay clean forever because ethics change.

development. A more in depth discussion on the common functions of corruption will be described in Chapter 3.

Social Norms

Finally in answering the original question, what is the impact of corruption on firm performance in Indonesia, it is important to understand how common corruption is in day to day businesses operations. The predictability and culturally ingrained ness of ‘corruption’ in a country’s behavior and business practices determines not only how corruption manifests itself in practice, but ultimately its effects on firm performance, and development as a whole. Of primary importance, whether corruption appears expectedly or unexpectedly in a society determines whether a firm which encounters it merely feels a bump in the road or drives blindly and fatally off the road and into a tree.

In the case of Indonesia corruption has manifested itself more or less in the same way since before it was even a sovereign country. Wertheim makes an example of the Dutch practice of colonial rule where a colonial administrator

“owed his superiors a regular charge that could be described as a ‘license to hold office’ in return for which he could anticipate, in addition to his **small** salary and a share of the district crop yield, more or less open payments from Dutch business interests he had assisted in the course of his duties.”⁵

Indonesians adopted most of their bureaucracies and practices from the Dutch, and the practice of giving small official salaries and supplementing them with assumed future bribe revenues continues to this day. As a practice, it particularly thrived during the economic boom period under the dictator Soeharto’s iron fisted rule from 1965-1998.

⁵ W.F Wertheim, *East-West Parallels: Sociological Approaches to Modern Asia*, Chicago Quadrangle Books, 1965, as quoted by Scott 1969.

And over that period, there is evidence that the practice did not really change despite rapid economic development. Macintyre points out that if

“if one were to scan the pages of the press ten or twenty years ago one would encounter the same complaints [on certain corrupt practices] about an older generation of players. In short, although many of the characters surrounding Soeharto had changed, the same basic pattern had been in place since the early days of the regime.”⁶

Recent literature and my own research indicate that the same behaviors and practices of clientelism still exist today after the fall of the dictator, though in just a more haphazard and decentralized manner.

Corruption and the way it is practiced in Indonesia are as old as Indonesia itself. This is not to single Indonesia out as a profoundly corrupt, culture. The Dutch and other European colonial occupiers from which many South East Asian nations adopted their modern corrupt practices were historically corrupt as well, rather only their notion of what constitutes acceptable and unacceptable (i.e. corrupt) behavior has changed. Chapter 3 and the appendix outline more specifically the function and purpose of corruption as a cultural behavior in Indonesia’s case.

Understanding how cultural and social norms integrate with corrupt practices is essential to assessing the presence of corruption on firm performance. This is because the practice of corruption in one country does not necessarily have the same intended effect in another. The social, legal, and cultural aspects of the society in which corruption exists determines the form in which corruption manifests, which in turn ultimately determines the effects it will have on a society. A clear example of this can be seen in a comparison between corruption in Asia and Africa. Very generally speaking, in many Asian countries, a corrupt transaction such as a bribe or equity sharing agreement

⁶ See Macintyre, Andrew, 2001,

with a government official is often seen as a contractual agreement, and not always a parasitic payment. From my research, continuing and often personal “good human relationships”⁷ are often formed between those who pay and receive bribes, where insider information can be shared between government and private actors and repeat mutual assistance provided. In this sense, corruption is more organized and predictable, with a higher potential for a productive and mutually profitable outcome. Reja and Talvitie reiterate this notion saying that in Asia,

“corruption becomes part of the fixed cost of doing business, when parties to a corrupt contract can invest ex ante on developing a “relationship” – a governance structure – to organize and safeguard transactions. It is not argued corruption is like a tax, rather it is a **part of group behavior caused on human drives and not money.**”⁸

Conversely, they claim that in Africa anecdotal evidence indicates that most corrupt transactions fall more into the category of parasitic, with government officials more often renegeing on promises or going back to request unscheduled additional bribe payments at unsolicited times. Corruption in this context was termed by Talvitie and Reja as “a variable cost” and was one of the [many] reasons why firms in Africa had much more difficulty attracting foreign aid and achieving higher levels of economic development, (though there are clearly many issues other than corruption which inform the difference between the two regions). Further theoretical basis on the contractual and other functions of corruption will be discussed in more depth for Indonesia’s case in Chapter 3.

Summary of Ideas thus Far

⁷ This was a term which one manager used, though other interviewees used different terms to describe essentially the same thing.

⁸ Talvitie A. and Reja B, *The industrial organization of Corruption: What is the Difference in Corruption between Asia and Africa*, World Bank,

This chapter has thus far pointed out the difficulties in defining corruption, as well as its legal, social, and cultural implications. But after discussing the difficulties inherent in defining corruption in a universally applicable way, I have yet to conclusively define how it will be used in this analysis in one clean sentence. Despite the context specificity and inherent loopiness of trying to pin down a single definition of corruption though, I believe there is something which defines how “corrupt” a culture is. And I don’t think it can be measured by a simple index (e.g. Transparency International, Business international, etc), nor can you rank countries using a simple number. Corruption, simply put is marked by a culture which often tries to find the “odd way out”. It is a culture which looks for loopholes in laws. Secrecy and intransparency is present in most such transactions, but not always. The bounds of legality are often trespassed but by no means, not all the time. But in a corrupt place, when a transaction which most outsiders consider corrupt takes place, the expectations and norms for common practice within that society and of the people involved, are for the part **not violated**. This is because the ultimate measure of what constitutes proper legitimate behavior, proper corrupt behavior, and inappropriate corrupt behavior ultimately falls to a cultural value judgment. This tendency to expect informality or ‘corruption’ as common practice, without having any moral qualms raised, indicates to me that ‘corruption’ or ‘corrupt behavior’ is a culturally derived perception.⁹ Or, in less abstract terms, corruption is a culturally derived norm defined by a familiarity and willingness to engage in corrupt’ or more ‘questionable practices.

⁹ Note: What I call ‘corruption’ above (i.e. the judgment that more ‘questionable’ transactions fall more often within the bounds of acceptable behavior), the legally and transparency minded might more aptly call pessimism.

Chapter 1 Part 2 : The Literature Review

The second part of this chapter seeks to review the literature on corruption as it effects development and firm performance. I discuss two major areas in the literature on this topic, one modern (1990's- present) and the other older, from between the 1960's-1980's. In brief, the older literature is mostly pragmatic on the subject, focusing on corruption as a behavior which can be detrimental or beneficial to firm performance depending on the surrounding context and function of corruption. More influential in the current development policy-making environment though is the more recent quantitative economic literature, much of which was written around 1997, around the same time many international organizations such as the OECD and World Bank started launching anticorruption programs. Much of the newer economic literature focuses on corruption as an exogenous disruption and analyzes its impact on efficiency and costs as they effect variables associated with economic development and firm performance (e.g. bribe costs, time spent in bureaucracy, foreign direct investment, etc.) The literature done by the World, Bank, IMF, OECD and other Washington consensus bodies view corruption as being a distinct phenomena, separate from the local developmental contexts in which it exists. Wolfensohn, the head of the World Bank has called it a "disease"¹⁰. Transparency international, the international anti corruption watchdog institution which makes the numerical TI Corruption Perceptions Index, went one step further in their recent advertising campaigns, calling corruption a disease which kills babies¹¹. Unlike

¹⁰ Refer to the 1997 annual World Bank address

¹¹ A link to an online clip of this commercial can be found at http://transparency.org/un_day/dnld/plag_eng.avi

how I discuss corruption in this paper, they view corruption as an exogenous and correctable market distortion, the magnitude of which can be measured quantitatively across countries and used to comparatively rank them. Within the latter view exists a much more unified consensus that corruption is bad for development, and in the cases where corruption seems possibly irrelevant (e.g. corrupt countries having high gdp growth rates), it's actually bad if you look close enough. I discuss below a brief summary and analysis of these three literatures. Again for the purpose of narrowing this (considerable) literature, I will be focusing on the effects attributed to public-private corruption.

Old Economics (Pre 1990's)

To start, I repeat that corruption serves a different function in different institutional settings. There is no denying that in a significant share of the cases, corruption and unchecked greed are bad for development and firms (well, those firms which are not government cronies at least). But within the context of obtuse and inefficient bureaucracy, corruption can serve to bypass cumbersome legal proceedings. Nathaniel H Leff (1964) makes this point saying: "if the government has erred in its decision, the course made possible by corruption may well be the better one." He went on to state that in this case, corruption was the 'grease for the squeaking wheels of a rigid administration'. In this regard, many economists thought that corruption was a catalyst for development in undeveloped institutional contexts. Samuel P Huntington (1968) emphasizes the importance of corruption to the development process saying, "In terms of

economic growth, the only thing worse than a society with a rigid, over centralized, dishonest bureaucracy is one with a rigid, over-centralized, honest bureaucracy.”

There have been many counters to this idea that corruption can help development more than the lack thereof. A study has shown that countries with higher incidences of corruption tended to have more red tape in their bureaucracies, implying that the incidence of corruption and the dominance of the bureaucracy are endogenous¹². Similarly other studies by economists such as Gunnar and Myrdal (1968) and Bardhan (1997) point out that within corrupt contexts, there exists the incentive within the bureaucracy to work slowly so that a bribe will be paid to hurry things up. Bardhan points out that in Russia, there even exists a terminological distinction between taking a bribe for what you are supposed to do (mzdoimstvo), and that which you are not supposed to do (likhoimstvo).

But, regardless of the questions concerning endogeneity of corruption with inefficiency, the overall effects corruption has on firm efficiency are still not clear. Corruption is not the only factor driving the legislation of seemingly pointless and cumbersome laws or inefficient and slow bureaucracy. Lack of institutional capacity in third world countries explains the existence of dysfunctional bureaucracies more than the detrimental effects of corruption alone¹³. In this regard, I note, corruption functions in many different ways besides as a short cut through bureaucracy.

¹² See Abhijit Banerjee (1994)

¹³ Here I would point out though that lack of institutional capacity can be caused by corruptions negative effects on development. This again is a cyclical argument currently being held by the world bank and international consensus. I will address possible motives for this more in depth in Chapter 2.

Corruption can be seen as a haphazard, second best means of achieving informally, what would be costly or infeasible task given the institutional and social context. Where systems of legal judgment and enforcement are weak, corruption often serves as the second best way to get what you need. Scott mentions in the aforementioned case of the Thai military bureaucracy how corruption serves as an effective lobbying system. Similarly, he mentions when things go badly, such as if a horribly unpopular law is released, corruption serves as a release valve for social tension. If the passage of an unpopular law is fait accompli, the alternative to evasion (i.e. corruption) is often rioting against the government. Rather than as an inefficiency, corruption can be a safety net and support for an otherwise already lousy system of government.

Economics (non consensus)

Shleifer and Vishney's (1993) theory on the effects of centralized versus decentralized corruption is key to understanding how in Indonesia's case, during the economic boom period which occurred during Soeharto's dictatorship, corruption supported the effectiveness of the government, and by extension, development. They discuss the consolidation of corrupt institutions to explain how dealing with monopolistic corrupt agencies is better than dealing with disorganized or scattered corrupt agencies. When bribe takers are the sole provider of the services they offer, they will demand fewer bribes but charge a premium price. But because the bribe givers are the sole providers of the service they provide, they do not want to charge so excessively that they drive down the demand for the service they provide. Because only they provide that service, they can

plan on how much they will demand in the future, secure that another agency won't try to undercut them. Because of their ability to plan for the future, monopolist bribe takers are predictable and create fewer additional costs to businesses in the form of hassle time spent on haggling over bribe amounts, as well as a minimization in the risk of the agreed upon service being delivered.

In the case of a disorganized and decentralized corrupt agency setup, while the total amount paid in bribes is found to be roughly the same, there is an increase in time spent hassling over bribe prices. Because there are many agencies, which try to provide the same services, agencies have to compete with each other. Where under the monopolist a few bribes would have to be paid to one agency on a given schedule, in the decentralized corruption model, many smaller bribes must be paid to many institutional gatekeepers. Furthermore, when these bribe demands will come is not very clear, nor from where. The provision of the services agreed upon are arguably riskier as well.

This distinction in the structure of corruption within the government (or, arguably, even within the private sector assuming large enough private players) explains much of why Asia did not feel corruption as destructively as Africa. In the case of Indonesia, given the government's weakness in formal revenue collection (common to many developing countries), the centralization and coordination of corruption through the office of the presidency provided the funds necessary to supplement government salaries, and bolster institutional capacity. The stabilizing effects of a corrupt but predictable government was then transferred to private firms who could coordinate and plan their business operations. Firms who were who familiar with the practices associated with corruption, could in the best of cases become profitable government cronies and/or form

large indigenous business empires. For the firms who were out of the loop, they could minimize their associated costs of corruption.

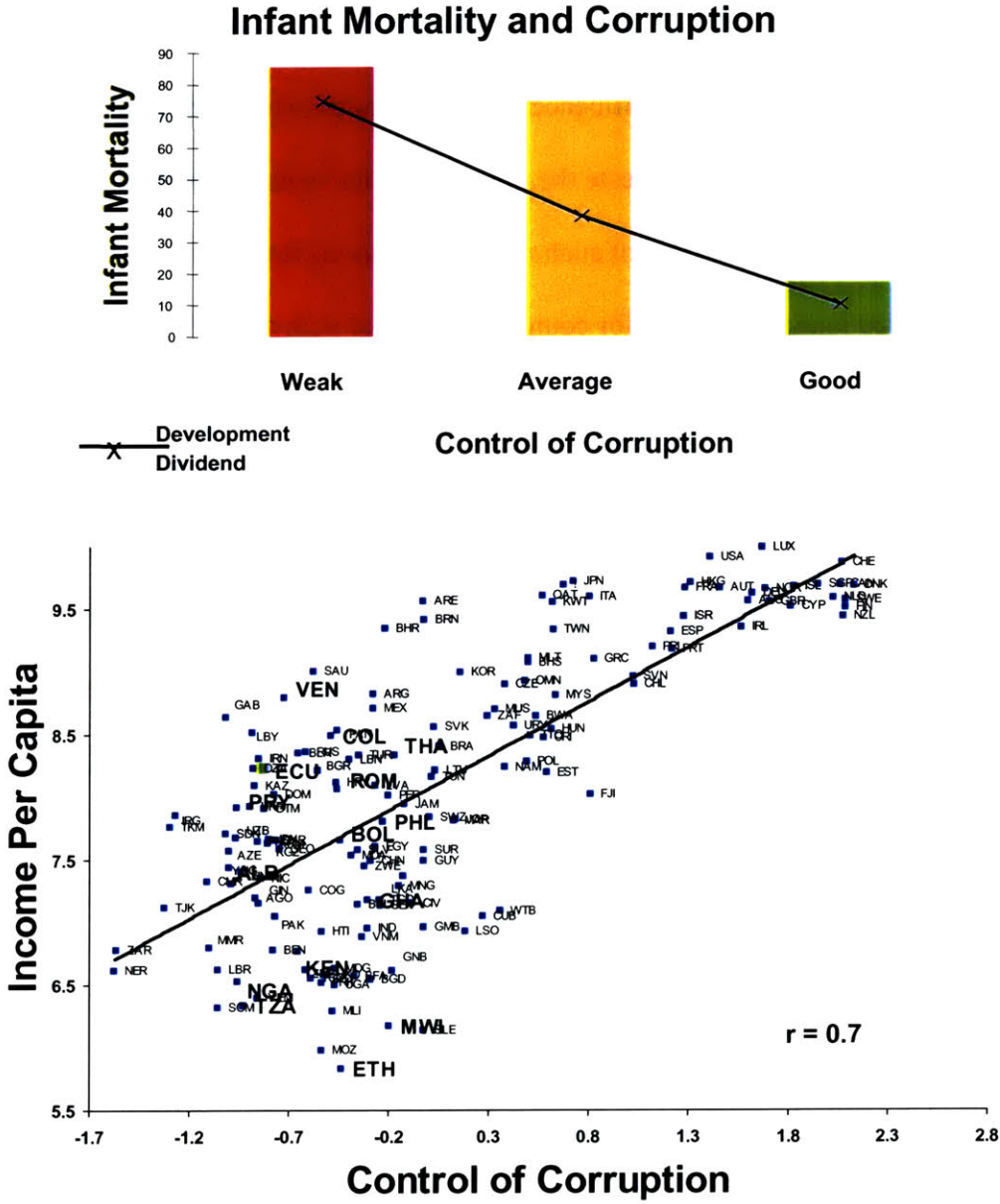
Economics (consensus)

It is clear that corruption can be beneficial, albeit while functioning in a second best, dysfunctional context. But over the past 10 years, a dominant consensus has arisen in the academic and policy making circles that corruption, regardless of its social and organizing effects, is bad for development . Susan Rose Ackerman speaks for much of the international development community when she says, “The idea that corruption can be economically benign or beneficial is now generally discarded.¹⁴” Viewing corruption as an additional transaction cost for business, there are many technical cross country econometric studies which show that more corruption, as measured by the Transparency international corruption perceptions index, is associated with lower gdp growth rates, foreign direct investment, and other macro economic variables. (Mauro 1995, Wei 1997, 1999, Campos and Lien 1999, the majority of WB and IMF funded studies, among others). In micro level business functions, Kauffman and Wei (1998) showed that there was a positive cross country correlation between corruption and firm manager’s time spent with government bureaucrats.

A significant proportion of the highly publicized studies on corruption rely on the TI index, and for the most part draw conclusions saying that a reduction in corruption creates direct returns for a country in the form of better economic development, as well as

¹⁴ Rose Ackerman: *Corruption and Government: Causes, Consequences, and Reform*, Cambridge University Press, Cambridge (UK), 1999; chapter 2)

most other development indicators. While corruption they claim, “kills babies”, reducing corruption alone , decreases infant mortality and spurs development.¹⁵



One concern with these studies is that corruption is viewed as a homogenous universally comparable variable, which affects different countries with different cultures and political

¹⁵ source for both figures is : http://www.worldbank.org/wbi/governance/pdf/poverty_course.ppt

contexts in more or less the same way. In contrast to the traditional view of corruption as a behavior, corruption is seen in the policy making literature as an exogenous factor effecting development, something akin to the incidence of AIDS or malaria. By doing so, many of these studies often associate institutional weakness with corruption, and usually cite reducing government influence, reducing trade barriers and other government imposed restrictions, which may create the opportunity for rents and rent seeking corrupt behavior to arise. Implementation of such recommendations is usually spurred by conditionally tied loan agreements for countries who deal with the IMF or other international lending agencies.

A concern with this strong arm approach to anti corruption, is that the intrusiveness of the policy recommendations may actually be more destabilizing on the governing systems they affect than on actually reducing corruption itself. Following this chapter, which reviews how corruption affects firm performance and economic development, I will discuss the effects of international anti-corruption policies in the world today, and their underlying motivations.

CHAPTER 2 The Role of Anti Corruption

Given the timelessness of corruption, this chapter asks why corruption is such a popular issue requiring international intervention? In it, I argue that international anti corruption campaigns are actually a political means of reinforcing the current trade hegemony of the developed world on the developing world. The stated goal of anti corruption for economic development for the third world conversely, is not clearly supported by the anti corruption policy.

“Campaigns against corruption are hardly new. But this decade is the first to witness the emergence of corruption as a truly global political issue eliciting a global political response... The 1990’s we would predict are unlikely to pass without the achievement of significant legal and institutional anti-corruption reforms.¹⁶

Like corruption, anti corruption is not new but a series of events in the early 1990’s caused anti corruption to take the forefront of international attention. Various corruption scandals which broke after the fall of communism, as well as increasing frustration from foreign donors about the futility of their aid money, raised a new public awareness about the frequency of corruption in the world, and, raised a great moral outcry. With greater public pressure, countries around the world demanded their governments and the large development organizations including the UN, IMF, WB and US to do something about the new wave of corruption.

A significant difference between the current debate on anti corruption and previous ones is that the marketing of anti corruption efforts is largely an international one. Previously anti corruption efforts were mostly domestic affairs, with government trying to deal with corruption within their own borders. Starting in the 1990’s international organizations and the IMF in particular justified their often intrusive prescriptions by couching their policy requests for anticorruption within a dialog of

¹⁶ Glynn, Kobrin and Naim 1997:7 as quoted by Williams and Beare 1999

altruism, often highlighting the deleterious effects of corruption on economic development and human well being. Corruption has been called a “cancer”¹⁷ (Wolfensohn, et al), “disease” (TI, et al), “virus”, as if it were some sort of disease without geographical or political boundaries. In this discourse, corruption has become synonymous with poverty. Conversely, The reduction of corruption through the adoption of anti corruption policies will reap great “development dividends”¹⁸.

Because societies often value their economic well being in practice more than they care about abstract notions of good or evil, the wide spread adoption of the belief that corruption destroys development would explain the sudden boost in popularity anti corruption efforts gained in the 1990’s. Since 1990, blaming lack of development on corruption, 11 Latin American heads of state were impeached or forced to resign before the end of their terms for corruption related reasons. Italy’s Silvio Berlusconi, Venezuela’s Hugo Chavez, Russia’s Vladimir Putin, and Indonesia’s Gusdur, Megawati, and recently elected Susilo Bambang Yudhoyono all came to power by slinging accusations at their predecessors and claiming that they would fight corruption in the name of economic progress¹⁹. But all of those countries are still for the most part considered corrupt, and as of this writing Silvio, Gusdur, and Megawati have all been ousted with charges of corruption. Regardless, the strength of this belief is highlighted by the fact that despite evidence to the contrary, fighting corruption has become a popular cause because of its association with the promise of economic development.

¹⁷ World Bank 1997a:2

¹⁸ Kauffman said this somewhere. I think the ppt at the end of chapter 1.

¹⁹ See article by Naim in Foreign Policy March/April 2005

But while corrupt practices may or may not be bad for development, the reframing of corruption as a scourge of development by the international academic, policy, and business community glosses over the realities and complexities inherent in the development processes in individual ‘corrupt’ countries. The propensity of the development community to oversimplify the issue by blaming corruption for the ills of development may lead to the stigmatization of all developing countries as corrupt, even where corruption is not the primary concern. On the other side, exists the belief that the adoption of decidedly western practices of democracy, transparency, and economic liberalization through privatization lead to economic development and forward thinking, though such policies in reality have been shown to increase corruption through the expansion of rent seeking opportunities²⁰. Examples of this can be seen in the economic liberalizations of Russia, China, India, Vietnam and Cambodia among others.

Corruption is not a uniform “cancer” on development as Wolfensohn, the head of the World Bank put it. It is a cultural manifestation of local business practices. And like business practices, the success or failures stemming from those transactions are highly dependent on the skills and circumstances of the people involved. Assessing the effect of corruption on development is a technical business debate, and not a moral one. This was the traditional international view of corruption for the business community, and before the big slew of anti corruption conventions in the 1990’s, it was the general consensus. A clear example of this is that up until the signing of the 1997 OECD anti corruption convention, for most OECD countries except the USA, Canada and Britain, bribes paid to

²⁰ See Rajagopal 1999

foreign officials were tax deductible as long as the name of the foreign official paid was listed. Belgium, Luxembourg and Greece did not even require a name²¹.

Given that corruption was until fairly recently a standard facet of international business practice, how has corruption suddenly and recently become a moral debate with huge supposed implications for development? One explanation could be that anti corruption has gained popularity as a form of venting frustrations against incompetent governments. But of more import to the policy debate and formation of anti corruption policies is the recent academic literature, which for the most part claim a strong negative relationship between corruption and development. One important thing to note is that the majority of the empirical and academic observations on corruption are done by the same institutions charged to combat it, namely the World Bank and IMF. This presents a potential conflict of interest since transnational organizations and large countries such as the US have pre-existing political agendas in regards to the developing “corrupt” world and can use anti corruption as a means of piggy backing their own agendas. This bias affects the way corruption is framed in the research. Most notably the emphasis on corruption is primarily on how it affects international trade and foreign investment. I argue in this chapter that trade and market imperatives by the developed world drive the underlying empirical analysis which informs the current anti corruption debate.

For the purposes of this chapter, in order to gain a better understanding of the goals of anti corruption, I deconstruct the origins of modern anti corruption efforts in order to highlight the assumed dynamics, which are responsible for corruption’s perceived positive or negative effect on development. The next section briefly highlights

²¹ Kaikati, Sullivan, Carr, Virgo, 2000

some of the major prescriptions given by large anti corruption actors, namely large development international organizations and NGO's. Following this I will describe the history of the anti corruption movement and how that informs the current debate. Finally, in order to gauge the accuracy and impartiality of the current consensus, I will outline the new empirical analysis justifying the current international anti corruption policies.

International Approaches to Anti Corruption

Unlike the complex context specific definition of corruption outlined in Chapter 1, the majority of the anti-corruption debate by the international development community generally address/define corruption as bribery from foreign companies to local officials (public private). In attacking this defined problem, individual countries usually have little say in the international anti corruption efforts. International anti corruption measures are by and large a foreign, top down affair where local (presumably corrupt) governments are not engaged and marginalized from the debate. By simplifying corruption down to the simple act of bribery and viewing the issue as a foreigner has strong implications on how corruption is framed in the international debate. As a result, there is little emphasis placed on the specifics of individual countries, and corruption is seen as a homogenous element across countries, which is only differentiated by magnitude, but not anything more specific than that. This analysis is not anthropologically based; rather corruption is analyzed in a cultural vacuum, choosing rather to model empirics with general theories and economic equations.

Policies to curb corruption can furthermore break down roughly into two categories: policies which try to lower the supply of corruption, and policies which seek to decrease the demand for corruption. The core assumption underlying this dynamic is that corruption, defined here as a public-private affair, necessitates a corrupt government officer who will supply corruption by requesting or demanding a bribe for services (defined here as the supply of corruption) or conversely, a private businessperson who will push a bribe to a government official (defined here as the demand for corruption). There are two general groups of actors who carry out these policies. The IMF and World Bank have more direct contact and influence on developing country governments due to the nature of their tasks and attack the supply, the US and OECD attack the demand.

The World Bank and IMF address the supply of corruption in host countries (namely, the government) by trying to limit the power of government. The two have different charges; with the World Bank mostly trying to limit the amount of perceived malfeasance in Bank funded development projects by requiring more transparency and accountability. An anonymous source who previously worked in the World Bank on anti corruption describes the prescriptions for anti corruption stating that the “gist of it is that corruption is a social disturbance, so you need to expose it when it occurs, address it very explicitly and publicly (name and shame) to increase the cost of corruption for the government officials who partake.”

The IMF has a much more widespread and intrusive strategy on anti corruption. During the last great purge of corruption, the Asian financial crisis, the IMF was the leader of the international anti corruption effort, which included the World Bank. Most prescriptions by the IMF embody the core ideology of globalization, with wide sweeping

calls for reduction in the size of governments in less developed (and presumably corrupt) countries in order to minimize the number of potential cases where corruption can occur²². Prescriptions often propose trade liberalization in order to eliminate tariffs, quotas, license requirements and other forms of regulation in order to minimize government involvement in business. In the case of Indonesia, the IMF has withheld critically needed funding in times of crisis on the grounds of corruption and not following through on structural readjustment as a means of enforcing compliance. The World Bank has only done this once and temporarily, with Kenya

The United States, OECD, OAS, WTO and UN fall more on the side of curbing the demand for corruption. Essentially all of their major anti corruption efforts have sought to punish their own member firms when they are caught pushing bribes in foreign countries. The UN and WTO go one step further, and try to make governments hosting corrupt activity more accountable to international courts or sanctions. In order to more effectively enforce international anti corruption through curbing its demand, there exists a consensus that corruption must be approached in an international and integrated way where all countries must cooperate in order to root out and punish corrupt practices by their own firms wherever they occur. The idea behind this is that if only a few countries follow anti bribery conventions, there exists the danger that those who do not can step in and supply the local government appetite for bribes and gain a competitive advantage against countries with non bribing firms.

Below I outline the history of how these anti corruption policies came to be, starting with the United States Foreign Corrupt Practices Act.

²² Krueger various years and Ackerman (1999) give examples for the reasoning behind this.

The Roots of Modern Anticorruption, The FCPA

Prior to the development of an international consensus on corruption, corruption was seen in much of the developing world as a domestic affair, the purpose of which was often as an excuse by the government in power to politically sabotage the careers of rival politicians²³. The United States Foreign Corrupt Practices Act passed in 1977 was the first legislation made where a country with clout wished to control the business practices of its citizens beyond the reaches of its own borders²⁴.

The FCPA was originally created during a national moral outcry following a disclosure made in the Watergate scandal that US firms commit wide scale bribery with foreign officials around the world. An SEC report in 1976 following the disclosure indicated that 117 of the top Fortune 500 and other large US corporations had given out over \$300 million in illegal payments to foreign officials. Appealing to strong public outcry, Congress passed the FCPA to specifically address the issue of overseas bribery, and only bribery. The early emphasis on only bribery may have been indicative of the fact that the legislation was ad hoc and congress did not really know what other forms of corruption to look for. The first provision of the FCPA requires US firms to keep detailed accounts of all foreign payments and transactions in order to provide transparency. The second, and more stringent provision prohibited all American businesses and individuals from making bribes to foreign officials in order to influence government behavior. This provision was so vaguely announced that behavior which

²³ Prominent examples of this can be seen in Indonesia, Ghana, Nigeria, Italy, the list goes on.

²⁴ Williams, Beare 1999

would have been legal in the United States (e.g. funding a political lobby group, contributing campaign funds to a politician, or even wining and dining a group of politicians) had become illegal if practiced abroad. Despite this inconsistency, failure to comply was punishable by tax penalties, heavy fines, and even prison terms for American firm executives²⁵. Regardless, the bill was passed with much fanfare, and was hailed as a moral triumph. President Carter signed it in 1977.

But it was a short-lived moral celebration. Originally, the drafters of the FCPA believed that other developed nations would come to an international consensus and criminalize international bribery on the part of their own firms. The United States soon realized that no other industrialized countries in the world were willing to follow suit, and that the FCPA had legally limited the competitive advantage of US businesses abroad against other developed countries such as Japan, France, and Germany, for all of whom bribe payments were still legitimate tax deductible expenses. Later attempts to multilateralize the FCPA led to a meeting at the United Nations in 1981, and failed in finding converts. A primary reason for this is that, at least in the context of foreign firms in developing nations, corruption was and is still assumed to be a highly profitable practice for those who participate. Morality on the other hand is quite costly. A Justice Department official said after the signing of the act, “compliance with the new act may not be costless for the United States. But living up to one’s principles rarely is”²⁶

Completely repealing the act would have caused loss of the moral high ground, which was behind the implementation of the act in the first place and was politically infeasible, but the American business community felt something needed to be done.

²⁵ Hines, 1995

²⁶ Heyman 1979, as quoted by Randall 1997

Between 1977 and 1988, congress amended the original act six times in order to make it more lenient towards US firms trying to bribe foreign officials, but the greater business community in the United States thought that this too was not enough. In the end, the best solution seen by the United States government was the multilateralization of the anti bribery convention so that other developed nations would be tied by similar rules of play²⁷.

Finally, an amendment to the FCPA in 1988 required the president to pursue international cooperation with the FCPA, mainly with the purpose of restoring America's competitiveness in corrupt markets. Still it was years until the United States's push for multilateralization would gain ground in the international arena. Only after the fall of the Berlin wall did the tide begin to turn. Allegations of corruption in countries formerly vied for by the west and the USSR began to surface one after another. Like Watergate was a moral wakeup call for the United States, the fall of communism created a massive international outcry against a perceived global epidemic of corruption. This awareness of corruption created an opening for the US to internationalize the FCPA.

Following this, the Clinton Administration advocated, through the OECD to adopt an internationally binding anti bribery stance which represented “ a commitment to effective measures based upon agreement that corruption is both harmful to fair competition and to the political process.”²⁸, and which required that member nations strike down the tax deductibility of bribe payments by member countries. The OECD convention involved a gentleman's agreement between member countries to reel in

²⁷ See Klich 1996

²⁸ OECD, Council Recommendation on Bribery in International Business Transaction, 33 I.L.M 1389 (1994)

bribery practices so as to level the playing field between industrialized bribe and non-bribe giving countries. The primary concern from the beginning for anti corruption within the OECD was never reducing poverty as it is often portrayed in the discourse, but to level the playing field in international trade for primarily American interests.

In 1996, following the OECD agreement, the United States, pushed the WTO to increase transparency for all government purchases for all member countries in order to further stomp out foreign bribery. Given the fact that it relatively easy to hide evidence of foreign malfeasance, combined with the lack of enforceability by the OECD, the OECD convention really was only a gentleman's agreement. But the WTO, because it is specifically in charge of transnational trade disputes is in the position to enforce transparency in government purchasing contracts, much to the chagrin of the ASEAN countries hosting the meeting, who claimed that the new anti corruption practices threatened their national sovereignty. At the WTO meeting the Indonesian Trade and Industry Minister Tunky Ariwibowo said, "We do not have common standards on issues like corruption... Any effort to relate them to trade will be detrimental to the functioning of the WTO in the future"²⁹.

Following the WTO, the US put pressure on the IMF and World Bank to more tightly monitor funding projects, and to more thoroughly take action against companies and countries which gave and demanded bribes. Already under pressure from the international donor community concerning the failure of foreign aid and bank associated developments since the 1970's, both agreed to take up the anti corruption charge. World

²⁹ Wall street Journal, May 6, 1996, as quoted from Kaikati, Sullivan, Carr, Virgo, 2000

Bank president James Wolfensohn even promised that projects found to involve corruption would be cancelled.

The United Nations

To recap thus far, a large part of the international anti corruption movement was spearheaded by United States trade and business interests as a means of repairing the negative consequences of the original FCPA, which was originally a noble, if not misguided effort, at exporting American morality. But US trade interests were not the only forces behind the rise of anti corruption legislation. There was an anti bribery convention which was considered in the UN in 1976, though for political reasons deemed hostile to transnational corporations, it never reached the general assembly. During the early 1990's, changing conditions led to a revival of an anticorruption convention within the UN, though the UN convention against corruption was not approved until October 2003.

It is unclear where the impetus arose for the UN to adopt an anti corruption policy, but wherever it came from, it seemed to adopt similar qualities and serves as an extension of the pre existing trade related anti corruption measures pushed for by the US. Where the US and OECD look to stop firms from bribing, they have little say in what happens within the host country when an agreement (possibly corrupt) goes wrong. The UN convention is one based on "asset recovery" and seeks to provide legal recourse in cases of local malfeasance. In the cases where corruption is found the UN highlights as "a fundamental principle" of the convention the right to asset recovery in the case of embezzlement of public funds and confiscated property to the state requesting it. Article

43 obliges governments (presumably developing countries) “to extend the widest possible cooperation to each other in the investigation and prosecution of offences defined in the convention”, even when this means that illegality is not an issue in the host country. The convention requires that local laws in ‘corrupt’ countries may need to be changed in order to take into account differences in domestic law between foreign and local parties. Clearly, the UN convention against corruption follows a similar trend to US based initiatives: an emphasis almost exclusively on foreign-domestic private-public interaction, and the need for increased security for foreign (presumably developed country) firms in order to facilitate international trade and investment. The United Nations may have its own reasons for pushing for such a convention besides trade and development as well since the international legal mandate of the convention increases its own jurisdiction.

Regardless, the strength of the development association with anti corruption as a powerful means of piggy backing unrelated policies is displayed in the ratification of the 2003 UN anti corruption convention. Despite its orientation towards trade and foreign asset recovery, it is still couched in the anti corruption shroud of development mindedness and compassion. At the ratification of the UN’s anti corruption convention in 2003, Koffi Annan said quiet eloquently:

“The fight against corruption is not wholly a moral one, in the sense that it is a struggle against the intrinsic “evil” of corruption. Certainly there is a moral element--one, which cuts across all major religions and societies throughout the world--but the compelling reason for the struggle, is the suffering and deprivation corruption brings to whole societies, and to the world’s most poor. It is concern for the latter, rather than a distaste for the corrupt and their deeds, that rightly drives the global movement against corruption.”³⁰

³⁰ Said at the High-Level political Conference for the Purpose of Signing the United Nations Convention against Corruption, Merida Mexico 9-11, December 2003

The World Bank and IMF

The World Bank and IMF, because of their closer association with developing country governments, approach anti corruption by imposing conditional limits to specific governments behaviors and not on individual private sector firms. (i.e. they fight the supply of corruption). Like the United States, the anti corruption movement within the WB and IMF originally gained popularity as an escape route from a tight situation. Originally, the World Bank and the IMF because of their highly political and thus volatile nature did not vigorously approach corruption and anti corruption policies. Rather than challenge corrupt client countries, the common practice during the era of Keynesian state led growth in the global south during the 1950's and 1960's was to give the money to governments and ask questions later. The tide began to turn in the 1970's when the era of state led development began to lose momentum, and the neo liberal ideology gained sway in development circles.³¹

Central to this ideology was the belief that barriers to trade and government interference would create rents in the market through protections or subsidies, which would always be whittled away by destructive and unproductive rent seeking. Theories on rent seeking were used then to show that, theoretically at least, given the choice, developing country governments would not be able to resist bribes and corruption from firms who sought those rents. Anne Krueger, the former vice president for Economics and Research at the World Bank and current first deputy managing director at the IMF stated explicitly in her 1974 article, which is seminal reading for anyone at the IMF or

³¹ Polzer 2001

World Bank today³², that any rent created from any government intervention by a developing country will be whittled away by corruption and ultimately hurt the economy. Therefore, in order to attack the supply of corruption, tariffs and government imposed market distortions should be eliminated wherever possible, and for markets to take the place of government bureaucracies.

Because of the more intrusive nature of the IMF (and later World Bank) prescriptions, the debate on corruption was too controversial for policy implementation for years and remained as an empirical debate within the bank, but not as an explicit justification for its structural adjustment diagnoses. Like the UN and US based initiatives, despite its earlier start, the WB and IMF anti corruption movements did not gain steam until the 1990's as well. Following the end of the Cold War, other development institutions such as UNDP and UNICEF, as well as individual country donors began to heavily criticize the ineffectiveness of neo-liberal structural adjustment programs in developing most of the third world. This arose in part due to the publicity of newly revealed information about the funding of foreign third world dictators during the cold war³³. In response to this challenge, the World Bank and IMF responded by creating the good governance movement in the early 1990's. At the heart of the good governance movement was the belief that foreign aid was failing to help certain countries because they lacked the governance or institutional capacity to manage the foreign aid effectively. And at the center of this, as was the belief back in the 1970's, that corruption was the primary cause of this mismanagement. Wolfensohn brushes all political ambiguity aside in an address in 1997 where, quoting the WB website, "In 1996, in his second year as

³² It is cited by almost every IMF or WB corruption paper in the section of this paper

³³ Naim 2005

President of the World Bank, James D. Wolfensohn threw down the corruption gauntlet. During the Annual Meetings that year, Mr. Wolfensohn captured the world's attention when he vowed to fight the "cancer of corruption" that undermines development."³⁴ But this begs the question though, why did the World Bank and IMF only start publicizing corruption as an issue until the 1990's if it had been around as a significant issue since at least the 1970's?

Prior to the governance movement, corruption was already on everyone's minds, but no one said anything about it due to its political sensitivity. Robert Klitgaard after interviewing Bank staff on corruption found the following two sentiments:

1. Avoid the word corruption, emphasizing instead administrative efficiency, institutional development or the structural adjustment of government itself.
2. Sensitivities will be eased if practical workable ways to reduce corruption could be identified³⁵

In short, the reasons for not publicizing corruption were two fold. Firstly, there were battles within the Bank bodies concerning whether or not anti corruption should be an issue because such policies would impinge on state sovereignty, a politically tricky task no international organization would wish to tackle without rock solid justification. And secondly, no one really knew how to frame corruption in such a way that the term could be dealt with and measured given the limitations and constraints of the World Bank in actually handling the micro level economic complexities of corruption in the myriad countries in which it appeared. The movement towards a governance ethic helped shift the blame of non development on local countries and gave the diplomatic impetus to push

³⁴ <http://www1.worldbank.org/publicsector/anticorrupt/helping.htm>

³⁵ as quoted by Tesh 1999, quoted by Polzer pg.11

the agenda onto the side of those who wished to make anti corruption a public issue for the bank. But first the political issue needed to be addressed.

This is where the reframing of governance came into effect. Governance, and the seemingly benign study of effective administrative systems, allowed for the debate on corruption to be shifted from the political arena (i.e. an issue of trade), to the academic or empirical one (i.e. “it’s bad but we’re not saying it, the numbers are”). As long as the question of corruption could be framed in an empirical context, then all the Bank needed to justify its prescriptive neo-liberal ideology was to prove that corruption was bad for development. But how could they quantitatively compare the effects of corruption on development in such a way that would be accepted by the greater policy making community? Studies on the effects of corruption and development have been around at least since the 1960’s, and quantitative ones which measured corruption using indices at least since the 1980’s. The findings have been inconclusive and have gone back and forth for years, why the sudden certainty on the effects of corruption in the 1990’s? This is where Transparency International and the World Bank and IMF research arms come in, which I will discuss in the next section.

In summary, the origins of the international anti corruption effort informs the current understanding of corruption and its effects on development. While moral sentiment and public pressure created the impetus for anti corruption efforts, morality and developmental altruism did not form the core intentions of anti corruption policies. For the most part, the anti corruption movement today has become a means by which to carry pre-existing agendas forward and to impose greater controls and enforcement by the developed world on international trade on the perceived to be corrupt developing world.

Unfortunately, the original straightforward moral flavor of the original anti corruption drive is still present to justify current policies, though the agendas have become much more complex.

To review, the underlying beliefs guiding the policy are: corruption creates a competitive advantage for foreign firms or parties who control it, that corruption reduces the flow of foreign capital and hurts foreign investors, and ultimately, that corruption is bad for growth. The validity of this moral argument rests on the theoretical and now “empirically proven” assumption that corruption is horribly damaging. I assert that the moral assumptions concerning corruption and development are either wrong or extremely simplifying. I discuss some of the empirical analyses next.

The Empirical Analysis on Corruption

Empirical Analysis: Corruption and Foreign Competitive Advantage

An important thing to note is that the underlying motives for amending the FCPA assumed that bribery gave a competitive advantage to countries which did not participate in bribery. But the empirical findings on whether or not bribery affected competitive advantage are inconclusive. One of the studies which justified the multilateralization of the FCPA through the OECD was a study by James Hines, a Harvard Economist who showed that the FCPA resulted in reduced business activities in those countries where government officials usually receive bribes in the 5 years following the FCPA’s enactment, while other developed nations increased their direct investment in those same countries. But on the other hand, the difficult nature of data on corruption makes it hard

to actually find out how much the FCPA is responsible for these changes and damaging US businesses. The 5 years following the signing of the FCPA were lousy years for the US economy in general, and boom years for bribe giving rivals like Japan. The reasons for these changes were structural at the time, and the effect of corruption is unclear. Furthermore corporations who can get away with accounting irregularities within the borders of the United States are likely to be able to hide bribery practices overseas. There is little concrete evidence that US firms actually decreased bribe activities following the signing of the FCPA agreement, as they could have shifted the task of bribery to local partners or as is often the case today, found better ways of hiding corrupt practices. As a result, data on economic gains or losses is highly anecdotal and inconclusive³⁶. Furthermore, whether the threat of FCPA punishment restricted the actions of US firms is also up for debate. When corruption by US firms overseas was discovered, the US government was disinclined to prosecute it. From 1977-1988, the Department of Justice only initiated 20 anti bribery cases under the FCPA, the vast majority of which did not pay any fines or penalties³⁷. Economic damage from the FCPA was ambiguous to say the least. Still the fundamental perceived threat by US business men drove the political motivation for anti corruption anyway, and this belief that corruption destroys competition exists to this day and drives how corruption is framed in the policy debate. In summary, an American banker I interviewed cynically summed up this perception in one phrase. In reference to his work in Indonesia with potentially corrupt competition he said, “Gosh, I wonder why Crédit Lyonnais keeps winning our bids.”

³⁶ See Meny 1996 or Klich 1996

³⁷ See Randall 1997

Empirical Analysis: Corruption and Development

In regards to the studies on the effects of corruption on development, it is a tricky situation, both in regards to the methodology of the studies, and the potential underlying political motivations for them. The WB and IMF are special cases as development institutions because they are considered the source of most of the “go to” information for the rest of the development community. But they are in a questionable situation because they are in essence creating research which validates their own controversial anti corruption policies.

This research includes studies on corruption ranging from the very big to the very small, from transaction level game theoretical analyses on the dynamics of individual corrupt transactions to cross country regressions showing the relationship between corruption and variables commonly associated with development, namely, GDP growth rates, foreign investment, infant mortality and so on. I will not discuss the micro level analyses of corruption on firm performance as they are extremely heterogeneous, mathematical and based on too many behavioral assumptions to make the majority of them not generalizable in my opinion. The studies most commonly cited in policy debate are the aggregate cross-country studies they have done showing the aggregate effects of corruption on country development. Many of these were summarized in Chapter 1, and the IMF and World Bank’s studies are usually the most cited ones. Paulo Mauro, an IMF economist published and popularized the finding in 1995 that corruption and economic growth are quantitatively negatively correlated due to corruption’s adverse effects on FDI. Anne Krueger who started the ball rolling on the idea of the dangers of state

involvement in markets in her 1974 article³⁸ is currently the number two at the IMF and has since published other papers blaming corruption for bad bureaucratic quality (2002), slow growth (1998), and why trade liberalization is good for growth (1998), the same year the IMF was creating chaos with the Indonesia economy during the Asian Financial crisis³⁹ with its extremely controversial and intrusive neo liberal structural readjustment programs⁴⁰. As research organizations, even if their research is not impartial, there is a high probability that their findings are pragmatically driven.

Making research to justify your actions is not new. Generally, if you are not the United States, in order to carry out controversial actions on a world scale, you need to substantially justify why those actions are beneficial. International acceptance is gained through the creation of “data” which as I stated previously, can replace perceived political intent with elementary deduction, which, it is assumed, will ultimately lead to an unbiased right answer. Furthermore, easily displayed data can be empowering for “reformists and civil society and can generate the transparency which ‘can fuel a participatory process’”⁴¹. This quote was stated by Daniel Kaufmann, the Senior Manager for Governance, Finance and Regulatory Reform at the World Bank Institute and one of the bank’s most vocal proponents against corruption. Samples of the graphics he is referring to can be found at the end of Chapter 1.

³⁸ The Political Economy of the Rent-Seeking Society, cited 674 times as of April 26, 2005 according to scholar.google.com

³⁹ Radelet and Sachs 1999

⁴⁰ see Radelet and Sachs article for reference

⁴¹ Kaufmann, Pradhan and Ryterman 1998, as quoted from Polzer 2001

In order to create “data” though, there needs to be a similarly universally applied standard by which to measure corruption. Since such a measure can never exist for reasons I explain in Chapter 1, one way of measurement then is to create an index, which measures corruptions in different cases based on arbitrary assumptions of what define corruption. Such indices have existed in the past, but none have gained the universal recognition and widespread acceptance as the Transparency International Corruption Perceptions Index. The TI index has, since its establishment, been the dominant measure of corruption for any country for which corruption “data” is available (e.g. no North Korea) in the academic literature and policy debates. Transparency International’s stated purpose reads:

“A principal tool in the fight against corruption is access to information. It is in this spirit that we offer this web site to everybody with an interest in the fight against corruption. We hope it will make a valuable contribution to assessing the gains made in recent years, and to contemplating the challenges that still lie ahead.”⁴²

But like anti corruption policies following the FCPA, the origins and analysis underlying the TI index are not so straightforward. First of all, transparency international does not measure corruption directly; rather it measures perceptions of corruption, primarily by foreign businessmen and (presumably foreign) financial journalists and not locals or government officials. Secondly, the Transparency International Index is not a single survey itself, but rather it is survey of other corruption surveys. Every year surveys can be added or dropped, and as a result shifts in scores may reflect changes in methodology of measurement rather than any actual change in corruption. Finally, like the research done by the WB and IMF, TI is not completely disconnected from anti corruption implementation bodies.

⁴² http://transparency.org/about_ti/index.html

One possible reason for why the TI index is used so frequently in studies especially by the World Bank is that TI originally came from the World Bank. Peter Eigen, a high-ranking official in the World Bank left it to start Transparency International in 1993. This was by no means a planned conspiracy though; he was initially refused funding as an NGO by many sections of the bank. Regardless, the IMF, World Bank, and general academic community adopted the Transparency International Index upon its creation in 1995 as their measuring stick for corruption, and suddenly a clear empirical connection between corruption and development was apparent.

Historically the supposedly negative connection between corruption and economic development was not always as explicit as it is in the literature today. Prior to TI, there existed other corruption measures such as BI (Business International), DRI/McGraw Hill, Gallup and many others. But none of them have gained the recognition and applicability that TI has. For some reason, using the TI index, the findings of quantitative research on corruption seem to come up more conclusively against corruption. Below is a table from a previous study by Michael Harrison, which summarizes the findings of well-quoted authors about the connection between growth, corruption and foreign direct investment.

FDI and Corruption:			
<u>Results of Studies Using the Corruption Perceptions Index (started 1995)</u>			
Date	Author	Use of CPI as corruption measure	Result
1964	Leff	No	Bribery acts as “speed” money (i.e. it’s a good kick start to development)
1968	Huntington	No	No significant relationship between

			corruption & FDI
1993	Wheeler & Mody	No	No significant relationship
1995	Hines	No	No significance
1995	Mauro	No (used BI index)	Corruption negatively impacts FDI, implications for reduced economic growth
1998	Wei	Yes	Corruption acts as a tax on FDI
2002	Habib & Zurawicki	Yes	Corruption negatively impacts FDI
2002	Wilhelm	Yes	CPI explains variance of real GDP per capita

Table 1. From Understanding the Corruption Perceptions Index:

Additional summaries included in grey. Original table from: Application Issues for the Foreign Direct Investment Decision, Michael J. Harrison, 2004

Before, the general consensus on corruption was mixed and the effect of corruption on development was much less conclusive both qualitatively and quantitatively. After its adoption the idea that corruption was adverse to growth had more clout. TI was not wholly responsible for the change in public discourse though, as discussed earlier, world politics led to this belief. But TI as a tool, helped empirically validate that belief and justify the actions of those anti corruption actors who used TI in their research.

A large concern about findings based on the CPI is that there is a risk that it is the methodology that TI employs which draws the connection between growth and corruption, and not the actual damage caused to specific countries because of corruption. This is because TI does not measure corruption; rather they measure perceptions of corruption. Because it is based on perceptions and not actual numbers, countries, which are traditionally stigmatized as poor, may be associated with corruption and may suffer

undeserved low scores. According to a regression⁴³, the TI holds a significant correlation to gdp per capita. Combining this finding with the assumption that corruption leads to poverty would imply that poor countries are corrupt. But to do that would be to ignore the existing conditions of every country with low gdp/capita and simply call them corrupt.

Stigma is particularly important in determining the TI index, because it is based off of surveys with mostly foreign business people in developing countries. If the general community being surveyed shares this sentiment, it is no surprise then that poorer countries on the TI are consistently marked as corrupt. Furthermore, the results of TI indices, because the CPI has gained popularity as an indicator among the foreign business and investment community, may in turn influence the perceptions of those who are surveyed in the future for CPI scores. As an indicator of corruption perceptions, the results from the TI index may then have self-reinforcing results, which are purely rooted in perceptions of stigma but not reality. Because of the interconnectedness between perceptions of poverty and corruption, the methodology of measuring corruption may be fundamentally flawed.

Conclusion

The interconnectedness between the measure of corruption and stigma does not end with perceptions indices, but can be generalized to the anti corruption effort at large. International anti corruption efforts in the past have had very limited success, and even for domestic anti corruption efforts, outside of the examples of Hong Kong and

⁴³ <http://econwpa.wustl.edu:8089/eps/em/papers/0502/0502015.pdf>.

Singapore it is hard to find a case where any country intentionally and successfully reduced corruption in the civil service with an explicit anticorruption plan. It can be argued instead that anti corruption hurts developing countries more than anything else. First of all, if corruption is a perception more than it is an objectively measurable phenomenon, then the publicity generated by anti corruption hurts countries by labeling them as corrupt. There are few if no instances where a country known for being corrupt to begin with announced new anti corruption measures by publicizing a wealth of previously unknown instances of corruption, and was rewarded by its corruption score improving. Case in point, after the 1998 IMF structural readjustments, Indonesia's CPI ranking dropped to match that of Angola⁴⁴, a country which was at that time experiencing a continuation of a 25 year civil war, among other things.

The method of approaching corruption is a highly sensitive and specific task, which should be defined and framed to fit each individual country's context, and not based on an arbitrary foreign consensus of how the world should be. Given the high stakes and difficulties in measuring the effects of corruption on development, as well as the cultural in-grainedness of its practices, one would hope that any policy approach used in curbing corruption would be country specific, and take into account the many multifaceted forms in which corruption can arise. Unfortunately though, this is not the case. The large development institutions (The World Bank, The IMF, Transparency international, the UN, the OECD, the United States, etc) have all unanimously embraced the definition that corruption is simply the bribery of foreign officials. This simplification of the analysis is devoid of a cultural and contextual analysis, which has

⁴⁴ <http://transparency.org/cpi/2000/cpi2000.html>. For 2004 Indonesia ties with the Democratic Republic Congo, and is apparently worse than Sudan

led to the homogenization and dehumanization of corruption from being a complex and ambiguous cultural manifestation, to a simple blight to be squashed.

Without this simplification of corruption, the empirical analysis justifying the prescriptions for development becomes much shakier. Deconstructing the empirics and realizing the limitations within the analytical assumptions, as well as realizing the potential biases, which guide those assumptions, in the end brings us back to the uncertainty faced in the original literature before the 1990's.

To see the actual effects of corruption on development, you have to look at how corruption fits into the process of a country's industrialization process. Corruption, as I mention near the beginning of this chapter, is a cultural manifestation. It may be a completely predatory act, or it can serve different purposes in a society, depending on what form it takes (bribery, gift giving, collusion, unspoken agreements, etc). Without the further analysis of the individual conditions for each country, anti corruption glazes over the context specificity of each country and, as seen in practice, replaces it with the next best thing: foreign trade oriented, neo liberal, neo colonialist market ideology. Because if international anti corruption projects can't make individual developing countries into better images of themselves, then it might as well make them into what the "uncorrupt" developed countries want them to be. Case in point, all the groups which fund transparency international (e.g. USA, Sweden, Norway, Denmark, The Netherlands, etc...) ⁴⁵ happen to rank high on the CPI, as well as ardently support and lead the international anti corruption agenda.

⁴⁵ http://transparency.org/about_ti/support/funded.html

In Chapter 3, I outline the role of corruption in Indonesia's development process. This involves describing briefly Indonesia industrialization process thus far, the industries and actors, which were key to the country's development, and how corruption, among things, is responsible for the current economic state of affairs. (Which isn't as bad as Congo I might add)

This chapter discusses the impact of culture and history on the practice of corruption in Indonesia. The first part of this chapter identifies some cultural and historical trends in corruption and how they underlie current practices. The second part of this chapter asks how corruption fits into the development process and provides background to address the interview findings in the next chapter.

Since the lapse in the Indonesia Economy following the Asian Financial crisis, anti corruption has become a powerful political rallying cry in Indonesia. Following the fall of the repressive Soeharto regime and its censorship practices, domestic NGO's such as Transparansi and Indonesia Corruption Watch have formed to name and shame corrupt officials and publicize the corruption, collusion and nepotism⁴⁶ associated with the Soeharto New Order Government and his close knit group of Javanese elite and ethnic Chinese business group cronies. Following the economic crisis, everyone from local NGO's, international organizations such as the IMF and the rest of the Washington consensus as well as academics around the world felt vindicated in the belief that corruption was responsible for the horrible mess the country had fallen into; many went so far as to say that getting rid of corruption was the most essential act in getting the economy back on track.

But while Soeharto and the current government took the brunt of the blame for this corruption, historically, as far as the act is concerned, the practice of KKN, in more or less its modern form, has been the commonly accepted standard for doing business and running the country for longer than Indonesia as a country has been around. Corruption is not a simple violation of legal or ethical norms, rather it is a manifestation of the

⁴⁶ Referred to in Indonesian as KKN, *korupsi, kolusi, nepotisme*

underlying cultural value system, which defines acceptable behavior. Viewed in this light, rather than the modern economic analysis on the subject which focuses on the magnitude or frequency of “corrupt behaviors”, in order to understand the extent to which corruption is a disruption to business practices and market operations requires an understanding of the cultural behavioral expectations which arise in corrupt transactions in Indonesia.

Given that corruption is a behavior, in order to understand it’s full impact on business practices and economic development requires an explanation of the historical context and function that it serves in society. The first part of this chapter seeks to trace the history of common corrupt practices today starting with the period of the pre-colonial Javanese kings, through colonialism and up to the present post Soeharto period.

Chapter 3 Part 1) A Brief History of Corruption in Indonesia

Pre-colonial Java

Like many other regions in the world, power and influence in Indonesia has a history of being concentrated in the hands of an elite few. This applies to European monarchies involved in the colonization of the developing world and Indonesia as much as it does to the Javanese kings who were at the geographic and influential center of the Indonesian archipelago before it was unified through Dutch colonization. This is not a sign of political corruption in traditional societies, but part of a greater tendency to respect those who are in power.

Key to this belief is the connection between political power and wealth. Namely, while the modern view supposes that material wealth leads to political power, the traditional view is often that wealth naturally flows to those in positions of political power. In most traditional cases the king and the aristocracy occupy the higher levels. While the development of modern Western bureaucracies changed this view in most of the west, the traditional Javanese view of a strong ruler personally having access to all the country's resources was common in much of Indonesia arguably up until the fall of Soeharto. In describing former president Soeharto one Indonesian observer describes the patrimonial tendencies in Javanese culture to bypass more modern and western beliefs saying, "The abstract 'state' is less familiar than the 'father' figure who provides for and protects his flock."⁴⁷.

This is inline with other traditional societies where in order for the country to be harmonious, and not fall to fractious competing tribalism⁴⁸, power should flow to the center. In Java this is the king, whose exalted position is bestowed by the hereditary and divine and not by public mandate. Given this understanding of authority, power was often centralized where it existed in the hands of one or a few rulers. Traditional Indonesian mysticism saw power flow like a pyramid, with all the resources flowing up, with the king at the top, the aristocracy directly beneath him, and everyone else somewhere near the bottom⁴⁹. The ruler in turn justifies his exalted position through the redistribution of largess to keep public allegiances to him, and to keep the political structure stable. In order to do this, he needed to collect lots of funds, from all the sources available to him.

⁴⁷ Makarim, 2001

⁴⁸ This is described in the definition of patrimonialism by Weber, 1964

⁴⁹ Anderson, 1972, For further discussion of Javanese Mysticism, see Mulder 1999

Prior to colonization, merchants who came to trade in Indonesia had to pay tribute to the ruler of the states they visited to guarantee their own safety, either from bandits or from the ruler himself⁵⁰. (not unlike FDI in Soeharto's Indonesia)

The Javanese aristocracy, or the *priyayi*⁵¹ functioned more or less as equivalents of local government officials. Because under the Javanese system all land belonged to the king, land did not play a role in the status or influence of a *priyayi*, rather a noble's political, social, and military basis were found in his own peasant followings. Like the king to the *priyayi*, he purchased the allegiance of his own political base through the redistribution of his own wealth. In this way, each *priyayi* was king of his own territory, and this can be seen in how they were referred to. Prior to Independence, the *priyayi* were called *pangreh pradja* or "rulers of the realm. Following Independence, in light of new nationalist ideology and the highly pluralist nature of Indonesia, they toned it down a bit, changing the name to *pamong praja* or "guides of the realm"

The Period under the Dutch

The Dutch who came and colonized Indonesia perpetuated and even furthered a similar belief, except that in the place of a central local ruler of royal birthright, was a foreign power based primarily in modern day Jakarta and in parts of Sumatra. They had an even larger geographic claim, and adopted the policy of British divide and rule, where existing kingdoms and traditional governing systems were replaced with a government

⁵⁰ Anderson 1972, King 2000 as quoted by Arifianto

⁵¹ For more reference, see Berger (1997), Ong Hok Ham (2003), Mack (2001)

whose sole purpose was to secure the nation's natural resources⁵². In carrying out the management of this task, as explained in Chapter 1, the Dutch behaved in a similar way with many Indonesian bureaucracies today. The extraction of rents from the country as a whole to feed the center of power was not an anomaly, rather, rent seeking created the accepted foundations on which to base all behaviors and institutional processes. For clarification I repeat the quotation made by Wertheim in Chapter 1 which makes an example of the Dutch practice of colonial rule where a colonial administrator

“owed his superiors a regular charge that could be described as a ‘license to hold office’ in return for which he could anticipate, in addition to his **small** salary and a share of the district crop yield, more or less open payments from Dutch business interests he had assisted in the course of his duties.”⁵³

The Dutch perpetuated the Javanese practice of paying tribute to local rulers in order to perpetuate local rent seeking behavior⁵⁴. This most often took the form of clientelistic arrangements with the traditionally economically dominant ethnic Chinese-Indonesian merchant class, as well as the traditional political power holders, the *priyayi*. The Dutch gave the Javanese *priyayi* further means to accumulate personal gains over a wider geographic spread by transforming them into the indigenous bureaucratic elite for the expansion of their colonial empire, giving them significant control over the management of the greater archipelago as well as the best access to the Dutch system of education by the late 19th century. In short, the Javanese had exported the Javanese practice of rent seeking and cultural hegemony to the rest of the archipelago.

In order to counteract any resistance to the implementation of this new rent seeking government, the Dutch colonial legal system was designed in such a way so as to

⁵² Prencel, quoting Kingsbury 1998

⁵³ W.F Wertheim, *East-West Parallels: Sociological Approaches to Modern Asia*, Chicago Quadrangle Books, 1965, as quoted by Scott.

⁵⁴ King 2000 as quoted by Arifianto

legally bypass or negate resistance, which might arise from unfair practices on the part of the Dutch. The legal system was markedly malleable for the purposes of serving imperial colonial interests and enforcing colonial control.⁵⁵ Indonesia following its independence adopted its secular legal code from the Dutch colonial era legal system. Understanding the malleability of the original colonial legal system and its original intent is key to understanding how the courts in Indonesia under Soekarno, Soeharto, and even today are notoriously erratic and politically driven. This legal legacy is further discussed near the end of this chapter.

The Revolution and the Period under Soekarno

The clientelistic and patrimonial tendencies of the traditional elite in the colonial period crossed into the modern era more or less unchanged. For example, it could be said that the original founding fathers of Indonesia had more experience with informal off balance sheet forms of revenue than with formal fiscal budgeting. During the war for independence, hidden informal financing for the war effort against the Dutch was collected through pre-existing clientelistic arrangements, common between the senior military *priyayi* who would later run the country and their collaborating (and often ethnic Chinese) businessmen. These funds were hidden and managed through charitable foundations (*yayasan*) or in commercial joint ventures between specific government agencies and private companies, a practice that continues to this day⁵⁶. Today discreet

⁵⁵ Prencel citing Kingsbury 2002

⁵⁶ See Macintyre 2000 for more examples of acquiring off balance sheet financing in Indonesia

budgets are often used for a mix between development funds and illicit personal enrichment.

Following WW2 and the eventual independence of Indonesia from the Dutch in 1950, the founders of the new government, lacking the institutional capacity to create a federation of states, as was originally intended, fell back on traditional Dutch and Javanese practices of ruling from the center. Attempts were made by Soekarno to create a democratic system of governance and from the early period of Independence from 1950-1957 political parties ruled in an environment of state control. Economically and politically this was a considered a *jaman edan* or “crazy period”, where nothing seemed to work and the economy stagnated. This was in stark contrast to the “golden period” under Dutch rule, which, while corrupt, budgets (official ones at least) were almost never in deficit, and the country was economically managed remarkably well⁵⁷. Much of Soekarno’s period of economic stagnation was due to bad policy decisions and general government incompetence in managing formal budgets and the national currency, but a large part of this could be blamed on the disorganization of government actors and the decentralization of corruption. For example, political parties were always short on funds prior to elections, so they gave their cronies and allies import licenses in order to fatten their purses. With no coordination between parties, by 1954, there were so many import licenses floating in the market that 95% of listed importers could not be trusted as legitimate, thus destroying the whole purpose of requiring import licenses in the first place⁵⁸.

⁵⁷ Zanden 2002

⁵⁸ Ong Hok Ham, 2003

The period under Soekarno following this, from 1957-1965 saw the country fall back to the system of consolidated rule from the center with the implementation of “guided democracy” where in 1959 he suspended parliamentary democracy and used the wartime constitution of 1945 which vests “all power and responsibility in the hands of the President”. Essentially “guided democracy” was a populist dictatorship, which was supported by the public and military. Following the return to authoritarianism, he nationalized all foreign (i.e. mostly Dutch run) concerns in Indonesia in 1958 and implemented state led economic development import substitution strategies centered around the newly nationalized industries. The reestablishment of this system was similar to the original pre-colonial period of the paternal Javanese strong man at the center, though in this case with a larger geographic jurisdiction, and with *priyayi* installed as military bureaucrats leading key national industries and government bureaucracies. Like the previous Dutch, this configuration has been described in the literature as a corporatist organization, where the structure of the government facilitated the decision making power of the traditional elites. But unlike Soeharto who would later replace him, Soekarno never had complete control over the bureaucracies and the operations of the industries, many of which were functioning like individual fiefdoms with small kings at the helm. Within these bureaucracies and industries, as was the case in the larger national government, employment and spoils were distributed along patronage lines⁵⁹.

The period of Soekarno’s rule under guided democracy is recognized as one of corruption, clientelism and economic chaos with inflation hitting 600% by the time Soeharto came to power in 1965. But it is very difficult to determine the connection

⁵⁹ Berger 1997.

between corruption and economic stagnation because although the government was very corrupt, it was also amazingly inept in forming realistic policies, prominent among these being: uncontrolled use of the printing press to fund all government operations, the eviction of all Chinese from rural areas in 1959 despite the fact that they were the backbone of the rural economy and service sector in most areas, and possibly worst of all, the eviction of all Dutch and many Chinese from the country following nationalization, thus eradicating all in country human capital with business experience above the level of supervisor⁶⁰.

Soeharto and the New Order

Throughout this period, there were challenges to the rule of the *Priyayi* by new political groups formed since independence. But all chances of replacing the authoritarian rule of the *priyayi* under Soekarno were replaced by the military coup which installed Soeharto, himself *priyayi*. Following the coup, Soeharto brutally slaughtered all political opposition to the military hegemony in the name of an anticommunist pogrom. Soeharto ruled with an iron fist, and expanded Soekarno's corporatist vision with an even more state oriented development plan, focused on a tighter circle of patronage and loyalty under the direction of the President.

Given the chaos in 1965 and the following years, surprisingly quickly after Soeharto took power, the economy turned around. This is due in part because of the price of oil quadrupling in 1973 due to OPEC. The Indonesian government under Soeharto

⁶⁰ Ong Hok Ham, 2003

showed very adept skill at managing the macro economy, in very stark contrast to Soekarno less than a decade earlier. Unlike the xenophobic Soekarno, Soeharto gave early control of the government to foreign trained technocrats (“the Berkeley Mafia”) and quickly enacted many reforms to increase foreign direct investment and reengagement with the global economy. This included being one of the first countries in South East Asia to open the nation’s capital account, allowing the convertibility of the Indonesian currency, and many other outward oriented market reforms. Following the drop in oil prices and accompanying revenues in the mid 1980’s, the government very quickly and successfully changed from an ISI oriented government to a more liberalized manufacturing driven export oriented one, with manufactures going from 2% to 53% of all exports between the years 1980-1993.

Despite corruption being widespread throughout the government, and given the ramshackle economic performance of the similarly corrupt regime immediately prior, it is amazing how well the government performed. For example, in regards to the official government budget, healthy macro economic policies were at the heart of government operations. A ‘Balanced Budget Rule’ was even in the country’s constitution and enforced through presidential decree in 1969. Since the late 1960’s and despite the fact that since the 80’s most of the development budget was spent on foreign debt (today the government spends about 60%⁶¹), the Soeharto government never defaulted or rescheduled loans throughout its period of rule, rather it opted to cut domestic spending to meet it’s international financial recommendations⁶².

⁶¹ <http://www.bps.go.id/index.shtml> Indonesian statistical bureau website.

⁶² Macintyre 2000

Despite Indonesia's propensity for having off balance sheet budgets, the country was able to reinvest more of its windfall oil revenue into productive reinvestments, notably in food crops and social infrastructure than any other OPEC nation⁶³. Development was clearly at the top of the national agenda. Yet, corruption was just as present. This was prominently obvious in the clientelistic relationships Soeharto, his family and inner military circle had with the nation's business groups; and this power the center had over the country was considerable. Under the Soeharto government, the dictator had a very high level of control, was able to dictate the flow of bribe revenues and could limit how much individual regulatory institutions could collect. Because of the predictability and structure from a centralized corruption arrangement, businesses knew who in the government to give bribes, how much was expected, and how often. Invariably, some portion of this money always found its way up to Soeharto through the bureaucratic hierarchy. Sometimes this clientelistic relation took even more direct forms. Foreign business people often had to make joint ventures with companies owned by Soeharto's family or cronies. Of even more economic significance is Soeharto's connection with the ethnic Chinese business groups. In between 1979-1992, the top 20 conglomerates, the vast majority of which are headed by a single ethnic Chinese family usually with personal connections to Soeharto, accounted for roughly 25% of the entire national GDP, about the same share as the entire state enterprise sector⁶⁴. The same clientelistic relationship still existed between the same public-private actors as under Soekarno. It was just that everyone was significantly bigger.

⁶³ Hill 1996

⁶⁴ Hill 1996 quoting data from attachments to the president's address of state, from various issues.

The Post Soeharto Period 1998-Present

Amid the chaos of the East Asian financial crisis in 1998, Soeharto stepped down. In the ensuing political turmoil, Habibie, a long time crony and the then vice president took over. 3 more presidents would soon replace him within four years. This stood in stark contrast with the outgoing president Soeharto who had held onto the reigns of power for an extremely stable 33 years. This short political half-life would be repeated in every other sector of government as every president brought with him/her a new cabinet and set of ministers. Lifetime bureaucrats were quickly replaced by incoming ministers, only to be replaced a few months later by new officials. The previous system of patronage and bribery, which was the organizational basis for the government, lost its effectiveness as a means of protection or contract enforcement. This was partially because given the short half-life of bureaucrats, ministers and other government actors, a bribe paid today may not have any purpose because the empowered government gatekeeper might be out of the job before he or she is able to return the favor.

But much like history before, much of the ineffectiveness of the new bureaucratic environment was the lack of an organizing hierarchy. Indonesia had reverted to a Soekarno era kind of decentralized government, with government officials each trying to maximize the bribes and revenue they could generate from their own personal fiefdoms, without a stronger guiding force to keep them in line. A bribe to one gatekeeper by no means ensures the compliance of any of the other multitude of individuals whose

approval is needed. One Indonesian observer described the situation by saying, “Instead of having one Soeharto, now there are many little Soeharto’s”.

Reflections on Corruption in Practice

The interesting thing to note for this discussion though is not the difference between the economic performance between Soekarno under guided democracy and Soeharto. There are too many other variables, which can account for those changes. Rather, what is striking is their similarities. Both of them retained the same mentality of leadership and rule. Both adopted authoritarianism, ruled from a highly centralized government structure (though Soeharto did a much better job in keeping his organization in line), and distributed national revenues to their inner circle. It is certainly clear by now that traditional Indonesian political dynamics run completely counter to the dominant western notions of good government where popular political theory judges the legitimacy of a state on the premise that it is for the benefit of the masses and not the elite few⁶⁵. By this modern western standard, Indonesia is a very corrupt country. But the same behavior, which is perceived as corrupt today, has repeated itself throughout history. “Corruption”, being an organized patrimonial state, has been an established and relatively consistent system of government in Indonesia longer than anything else. Despite varying economic conditions, different governments, different industrial policies, and market

⁶⁵ See Rajagopal (1999) for a discussion on Eurocentric notions of state.

conditions, the same underlying ambitions and behaviors underscored all politics and big business since before the arrival of the Dutch.

Corruption is not a “blight” on development. Nor is corruption the malfeasance of a single individual. Rather, corruption has co-existed with development, and shaped how the state and society interact. It is not the prevalence of such a system as much as its guiding centralized structure which determines government efficiency. Given that corruption in Indonesia displays a historically consistent pattern, the next section of this chapter asks the question, how this system affects development in Indonesia.

Chapter 3 Part 2) Corruption and Property Rights

By western standards of modern, impartial and legalistic bureaucracy, Indonesia seems a very unfriendly place for business. Yet over the past 30 or so years, foreign direct investment flooded into Indonesia up until the Asian financial crisis and local business groups not associated with Soeharto’s circle grew rapidly as well. Many of the basic features businesses need, particularly property rights, were enforced despite the opaque and personal basis of government. Much of the literature explains this by describing Soeharto’s Indonesia as a well oiled system of patrimonialism, whereby a country’s government administration is a personal extension of the ruler, and where direct ties to the leader or the leader’s direct inner circle or family are essential for doing any sort of business. Another explanation for the system is the theory of the Kleptocratic state. Such a state is one where the government is set up such that the political elite has every incentive to achieve productive efficiency, insofar as they can directly benefit from

it. Like a private monopoly, output of goods and services will be restricted by the government in order to maximize its own profits.⁶⁶ What determines how effectively the government can extract rents from the market though, like a monopoly depends on how strongly it can command the supply of government services.

What sustains a politically and economically stable and effective patrimonial system run completely counter to modern democratic bureaucracy. While modern bureaucracies function best under democratic and legally guided systems with checks and balances, the history highlighted above shows that for Indonesia, a central unchallenged authority was necessary (but not sufficient) for a smooth running patrimonial state. Yet both systems can provide similar incentives for businesses. The reasoning for this can be seen in the monopolist bribe model described in Chapter 1 by Shleifer and Vishney. To recap, they showed that where a single monopolist exists in providing the supply for a set of complementary goods or services, the most common case being government licenses, he will keep the cost of bribes low so as not to drive down the overall market demand for the rest of the licenses. In this case, corruption is a minimal cost. In the case where more than one supplier exists to provide different complementary goods, it is not in their own interests to keep prices down and extract as high a price as possible for their own good, to the point of driving down the aggregate demand for government services. Competition is anathema to such a system. Bardhan points out that a weak central government, with its inability to stop the creation of independent corruption rackets creates great market inefficiencies, the presence of which might be able to explain the differences in economic development between democratic India and Soeharto's Indonesia. Where in Indonesia

⁶⁶ Olson 1993, as quoted by Arifianto.

the structure was tightly controlled by Soeharto's family and military elite in cooperation with the ethnic Chinese conglomerates, as opposed to India where corruption is more anarchic and fragmented⁶⁷.

But the cost of bribes alone is not necessarily the issue here. According to the interviews presented in the appendix as well as the literature, bribe costs are low and virtually irrelevant when compared to revenue in most industries, even when there are repeated contacts (and opportunities for bribe extraction) with rent seeking government agencies. Bribe costs as a percent of revenue, for all companies interviewed ranged from 1-4% of total operational costs. But Shleifer and Vishney's theory becomes particularly relevant when it comes to addressing property rights, which are essential for business, especially private investors. In most of the developed world, this implies a clear legal structure and fair judicial system. Both of these are absent from Indonesia, where Supreme court Justices have publicly ridiculed each other as hopelessly corrupt and Soeharto himself actually admitted that the legal system was beset with endemic levels of bribe taking.

Macintyre (2001) suggests that, at least in the short run, the centralized system of corruption in Indonesia served as an alternative to an up front legal system to enforce property rights. During the Soeharto regime, most regulatory and governing bodies (police, judiciary, etc.) functioned as little more than self-serving henchmen for corrupt government higher ups. There was a highly structured network of corruption set up in all government agencies which maximized the collection of funds from all levels and areas of government and sent an implicitly agreed upon portion of this revenue up to the

⁶⁷ Bardhan 1997

president himself, the remainder of which supplemented low official salaries in the department which collected the bribes. But in order to maximize the flow of funds to his own inner circle, Soeharto had to organize and monitor the collection of funds. This was done by putting military personnel as junior as colonel in every department of government, with the primary purpose of serving as whistle blowers if any given agency was acting too corrupt and damaging any long term prospects for future investments.

Strong political leaders are able to stop regulatory agencies from acting independently and to make sure that the aggregate amount of bribes collected by lower level agents is not too extreme, so that the total amount of funds which eventually flow upwards are maximized. An example of this can be seen in 1986, where the customs bureau was considered as being too corrupt and self-serving. In order to punish the customs bureau and set an example for other government agencies which wanted to break away from the social order and go into the business of corruption for themselves, Soeharto made them irrelevant almost overnight, by outsourcing customs to a Swiss customs agency⁶⁸.

In the case where there was decentralized corruption, such as is the case in Indonesia today, there is very little chance of being punished for corruption due to the lack of legitimate and empowered enforcers. Under a system of patrimonialism, the success of the system more or less lies in the hands of the leaders or elite to control the behavior of those below them in the hierarchy. Anecdotally at least, from interviews I have conducted the Shleifer and Vishney model more or less holds true. For example, under Soeharto in order to obtain a license or negotiate tax procedures, a single bribe to a

⁶⁸ For more reference on this see Hamilton-Hart 2001, Macintyre 2001 or McLeod 2003

district department head was all that was needed. It was then the district head's job to distribute that bribe payment around his department and send the remainder up the chain of command. The payment would be predictable and implementation or provision of the agreed upon service would be handled in an orderly fashion. Now, because the structure and hierarchy has broken, lower staff has become "*berani*", which is the Indonesian for brave or daring. Now, in addition to paying the district head, you may have to pay the field agent who delivers the service, the field agent's boss, and anyone involved in the process that may function as a gatekeeper. In this sense, corruption becomes chaotic and unpredictable because in order to accomplish a corrupt transaction you may have to pay many people unpredictable amounts of money at seemingly random intervals. While I stated above the actual cost of bribes is actually a very low compared to the money involved in most cases, there are other costs, which can significantly damage businesses. These include delays to business, managerial time lost with bureaucrats, and uncertainty in the provision of the actual service agreed upon.

This leads to the second issue, after the centralization and organization of corruption is its predictability. Reja and Talvitie posit that the main difference between corruption in Asia and Africa is that corruption in the former is part of the fixed cost of doing business, while it is part of the variable cost in the latter⁶⁹. A key element in understanding this is that the type of relationship in a corrupt transaction often determines the predictability of the corrupt relationship. Assuming corruption is a contractual relationship, there are two types of corruption. The first one is corruption purchased on the spot market, such as when one bribes a policeman in order to avoid a traffic ticket.

⁶⁹ Reja and Talvitie 2000

Whether the corrupt agreement will be honored is determined immediately and there is little risk of an ex-poste hold up given that bribery is known to be possible. The second type of corruption involves a longer time frame, where a firm makes an agreement with the government for a project contract, with a tax collector to evade taxes, or even with a judge over an ongoing court decision.

The second case has more potential for contractual hazards for both parties involved because of the possibility for opportunistic behavior. It is the case in much of Africa that businesses must give bribes to obtain government favors as they go, making them vulnerable to more opportunistic behavior. In Asia on the other hand “informal institutions” and other informal rules, norms and customs facilitate the development of established business norms and trust⁷⁰. All disputes are solved as informally as possible, avoiding the official court systems at any cost. In the context of Indonesia, the emotional and personal investment in the patronage system is reflected in what constitutes an acceptable bribe.

Corruption differs by country and what constitutes an acceptable bribe differs accordingly. Free vacations to Europe are appropriate and well-received bribes in the middle east, while modern western appliances from TV's to cars go over well in China or many parts of Africa. Eastern Europe likes cash and western goods while Western Europe and South America like discreet cash payments or transfers to Anonymous Swiss accounts. In Indonesia, Malaysia, Thailand and India, housing, transportation or college scholarships for official's children abroad are very persuasive and common bribes⁷¹. The

⁷⁰ Francis Fukuyama 1995 as cited by Reja and Talvitie 2000

⁷¹ Piturro 1992 as quoted by Herbig 1997

emotional and personal element is very important in clientelistic or corrupt relationships in Indonesia, and it is very arguably less distasteful to renege on your corrupt obligations with the man who gave you a TV or suitcase full of money than the person who is paying for your child's college education and housing abroad.

One note they make though is that stable governments need to be present in order to invest in such relationships and the informal institutions, which support them. In Africa, Reja and Talvitie blame short government half-lives and bureaucratic instability with why similar long-term relationships have not formed in more places. Following the ouster of Soeharto and the transfer to an unstable developing democracy, the stark breakdown in the strong patrimonial structure has disrupted the traditional practice of patronage and reciprocity. Public private relationships aren't as strong as they used to be.

To recap thus far, this chapter has discussed how given a patrimonial dynamic without a stable and functioning legal system, the Indonesian state was able to provide property rights and consistent contract enforcement through personal contact with government officials. Corruption affects business performance more negatively in Indonesia today, where the patrimonial system no longer functions and is currently being replaced with incomplete forays into democratic reform and increased unchecked political competition. Given this dynamic, patrimonial safeguards to destructive corrupt behavior no longer exist for many areas of the government and property rights are adversely affected. The unpredictability and loss of property rights associated with unorganized decentralization is one of the reasons why, anecdotally at least, corruption is seen as worse today in a democratic Indonesia than before under a dictator. The next section applies this theory to describe issues concerning the behavior of two areas of

government affected by this break down in hierarchy, and which are also now responsible for the most common complaints about corruption. The two cases are drawn from taxes and courts.

Chapter 3 PART 3) Relatively New Issues with Corruption

To keep things in perspective, before continuing with this chapter, I would like to make it clear that despite the historical and cultural ingrainedness of “corruption” in the Indonesian psyche and its more destructive nature now that it is decentralized, in actual business practice, corruption is not as ever present and debilitating as it may sound. The effects of corruption on business performance completely depends on the idiosyncrasies of specific industries, the frequency of their contact with the government, with what areas of government involved, and the stakes involved in such interactions. This can range from absolutely corrupt and dependent on corruption to succeed (e.g. the president’s government subsidized over priced protected natural resource project), to not corrupt (e.g. pure private high tech competitive manufacturing for export). The details of some of these distinctions are explained in the interview summaries in the appendix..

This distinction can be put in two general categories, corruption which is impersonal and affects everyone, and corruption which is an issue for specific firms given standard industry operations and behavior. But there are certain government agencies, which because of their jurisdiction, almost all firms will have to interact with at some point. Two sources of this kind of corruption are tax and legal. The remainder of this chapter discusses tax corruption as carried out by auditors and judicial corruption by

judges when a dispute is brought to court, and how the current decentralization affects their behavior. The effects of decentralization on the behaviors of tax administrators and the judiciary are listed below.

Taxes

Taxation presents a particularly attractive venue for corruption because of the large, potentially win-win long term stakes involved between tax collectors and businesses. James Castle, president of the U.S Chamber of Commerce in Indonesia complained that for foreign investors, that “the cost of ‘playing by the rules’ probably raises [a company’s] effective tax rate from 30% to 45-50%.”⁷² My interviews with local domestic and foreign companies more or less agree with this view though the exact value of money gained or lost is not so clear-cut. Because tax corruption is more quantifiable than other forms of corruption, it is informative to look at the underlying dynamics behind tax corruption first.

Ballas and Nielsen⁷³ describe a basic pattern of systematic extortion, which they claim existed in Italy at least until 1993, in Indonesia until 1998, and other Latin American countries today. A tax auditor or inspector tells a business manager that the official tax bill is \$5,000,000. This is often the accurate amount. But if the manager agrees to personally pay the collector \$100,000, then the business only needs to pay \$3,000,000 in taxes. However, if the business refuses, then the auditor often reassesses

⁷² This is mentioned in “Old game or new? Corruption in today’s Indonesia” This is a particular point of contention for the United States because the FCPA technically prohibits US companies from gaining access to these benefits through bribes.

⁷³ Ballas and Nielsen 2000

the tax bill to become \$7,000,000. Suffice to say, tax evasion is often forced on businesses, though tax corruption from firms bribe pushing is still a possibility. The unofficial revenue gained by the collector is then often spread around with other members of the corruption network, which often involves the judiciary, police, political parties and other agents who are responsible for monitoring and punishing such behavior. In Indonesia, my research shows that the same types of transaction more or less apply to all businesses. Foreign firms, including US firms, often use a local subcontractor to handle the illicit payment to the ministry of finance, though more stringent reporting standards for foreign firms make them less susceptible to extortion due to their use of big 5 accounting agencies, whose audits are more difficult to challenge by the inspector.

Such a procedure under the Soeharto regime was common, with the corruption network organized around the Soeharto family⁷⁴. Given the predictability of the regime, businesses often benefited from paying much lower effective tax rates than the law required. The bribery funds went like clockwork back to the department heads at the ministry of finance where they were redistributed to supplement the low official salaries. The remainder of the money was sent up the chain of command where part of it was used for off balance sheet financing of legitimate development projects and the other part, inevitably, to improve the quality of life for someone inside the upper echelons of the bureaucracy. In this system, businesses knew who to pay, and when. Audits were not very frequent and only came around when there were either severe financial irregularities (just because businesses are extorted doesn't mean they won't evade taxes as well), or if money was needed for a new big government project. This arrangement was favorable to

⁷⁴ Ballas and Nielsen 2000 citing Thones 1998, Zitner 1998

businesses and tax authorities. As one businessman put it, “Sometimes they would want some more money, and I would suggest we discuss it on the golf course.”

When the central authority fell apart in 1998, the simplicity of the system disappeared. It can be described roughly as going from a structured hierarchy to an “every man for himself” situation. To illustrate this further, I will explain some of the specific dynamics in Indonesia:

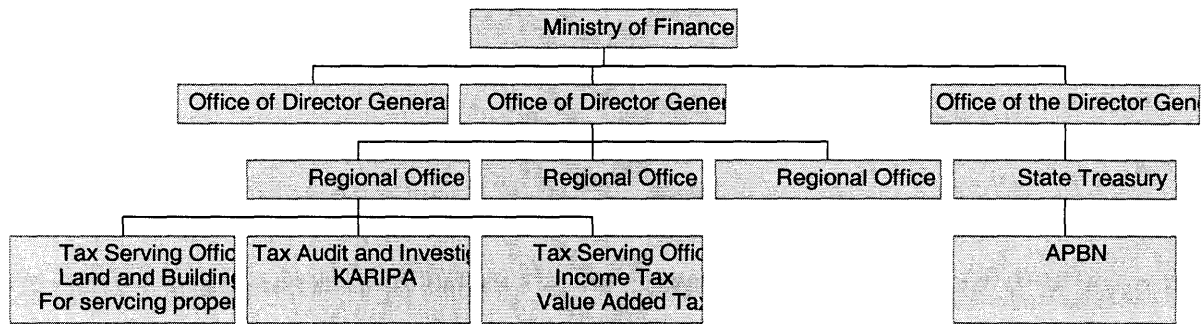


Figure 3: A simplified organizational chart of the ministry of Finance

Before, the process was relatively simple. It involved talking to a manager for auditing or tax services, preferably a senior one in the Director General’s office. The agreement on how much tax would be paid was made at the central office and a bribe would be paid, either in cash or a donation would be made to a charitable organization which was handled by someone in the MOF. There are many ways to launder money and I will not go into those details. In this negotiation, the amount of bribe required depended on the financial fundamentals presented in the audit. A company with windfall profits would be more vulnerable to a higher bribe demanded in order to avoid larger taxes. Conversely, firms with huge reported losses don’t need to pay a very large bribe because losses are not supposed to be taxed. As a result many businesses reported low revenues

to avoid taxes. The tax inspector's job was to try to call the business' bluff and argue revenues up. A bargaining game would ensue, and eventually a bribe and required tax payment would be agreed upon. This is the reason why some of the most financially successful companies in Indonesia are "unprofitable". This is not simply because of greed on the part of businesses, though greed is definitely a factor in most cases. Because there is no knowing how much the collector will assume a firm is bluffing, it may push up the required bribe payment arbitrarily. In many cases, it is other factors such as the personality of the tax collector or current institutional needs for informal funds, which determine how aggressive the collector, will be. For greed or prudence, it is common practice for firms to under report earnings. After all the negotiations are done a crew of tax collectors would visit the business office and work out the details and implement the agreement made with the manager. The crews usually come in groups of 4, one supervisor, one *ketua* or "senior", and one or two office clerical staff. They follow the boss's instructions and this usually seals the deal.

With decentralization, taxes become a much more unwieldy affair. Because there is no organizing hierarchy, everyone is in it for themselves, and there is very little enforcement in correcting the behavior of rogue bribe takers. While before if you approached the Director General's office everything would be finished, now, the regional office may require its own bribe which also requires its own separate negotiation process. Then, when the field staff come, often they will ask for a bribe as well before any prior agreement is honored, which requires yet another series of negotiations. Because of the lack of enforcement and accountability of tax officials at all levels, anyone *berani* enough

can ask for a bribe. An accountant told me that, “Under Megawati, there is absolutely no control! Even the clerical staff has started asking for money!”

As a result of the half way transition between a functioning Patrimony and a functioning democracy, taxes have become a much greater issue for more reasons than money alone. Certainly, with more gatekeepers, the amount of bribes has gone up (anecdotally at least), but the key difference is the rise in uncertainty. Many of the companies I interviewed reported audits every single year since 1998. During Soeharto’s period, it was relatively easy for an informed firm to know when they would be tapped to fund unofficial government activity. Now with multi party politics, the demand for funds increases dramatically before elections. And potentially most unsettling of all is the prospect of long term private culpability from all of this increased corruption. Corruption invariably leaves a small paper trail, and under Indonesian tax law, the government can go after you for up to 10 years after an audit, so companies who have been extorted by tax collectors don’t know if they are in the clear for a considerable period.

An accountant described the changes between the past and the present very clearly. While before the uncertainty faced in a bribery transaction was simply an equilibrium between the government’s greed and the business’ greed, now it is much more erratic. Now, in addition to greed on the part of the government and business, it now includes the uncertainty with the government agent in keeping his people in line, including the greed of individual government agents, as well as the uncertainty of how stable any final agreed upon price will be. Given the increasing number of disputes in taxation, it is becoming more common to settle tax issues in court. Unfortunately, the court is its own beast. I will discuss this next.

The Judicial System

If the tax system was an example of systematic long-term corruption, then the courts represent an example of a one-shot corruption transaction, one that is to be avoided by all means possible. The courts have traditionally been distant from the government and therefore unaccountable. Like the tax collection system, they are also systematically corrupt. Under Soeharto the court system had a specific unofficial task, which was to deflect legal challenges to the regime and the actions of private sector firms or individuals who were in clientelistic agreements with the regime, to impose legal sanctions on opponents of the regime, and finally, to provide attractive positions in the government where favored cronies could attain high bribes to influence decisions.⁷⁵ Helping achieve this end is the fact that Indonesian courts have no jury.

The origins of this purpose can be traced back to the Dutch from whom Indonesia adopted its legal system. The Dutch legal code for the Netherlands was designed to serve exactly the same purpose in colonial times as it did under Soeharto and Soekarno, and as such very few efforts have been made to modernize it since decolonization. The Dutch colonial legal system was designed in such a way so as to legally bypass or negate resistance, which might arise from unfair practices on the part of the Dutch. The legal system was noticeably malleable for the purposes of serving imperial colonial interests and enforcing colonial control.⁷⁶ The malleability of the legal system allowed more leeway for the legal system to be used as a political tool rather than as a check on judicial power. Modern day Indonesian secular law is based on the 19th century Dutch codes,

⁷⁵ Mcleod 2003

⁷⁶ Prencel citing Kingsbury 2002

which are somewhat vague and offer leeway for potentially arbitrary decision-making. There are concerns about the antiquated nature of many of these laws an example of which can be seen in the Asian Financial Crisis, when many Indonesian firms were going bankrupt, foreign Dutch lawyers were invited to help with bankruptcy proceedings to interpret the 85 year old bankruptcy laws which were still written in Dutch.

Legal issues aside, because of its detached position from the rest of the bureaucracy, the judiciary has become more empowered following the break up of the Soeharto franchise especially in the wake of the East Asian Crisis. Following the crisis, many creditors began to file bankruptcy claims against defaulting debtors and many disputed business assets had to pass through the judiciary on the way to the auction block. This took the form of defaulting debtors bribing judges to keep assets in the hands of the local conglomerate best able to make a decision worth their while, rather than follow the law and let assets go to foreign and local debt holders. An Indonesian businessman whom I interviewed involved in a property dispute went to a Jakarta based judge's house to negotiate a bribe payment. In this negotiation the judge openly admitted that the law was on the businessman's side, but he would have to pay a matching bribe to make the decision worth his while. This behavior is common and can result in drawn out legal proceedings which flip flop both ways to maximize the bribe payments which judges receive. Anecdotally, 90% of all commercial court cases are determined by bribes⁷⁷. A particularly spectacular example of abuse can be seen in the case of Tri Polyta Indonesia, the largest producer of Polypropylene in Indonesia, which sought to have the courts invalidate \$185 million worth of bonds it issued before the crisis began. It was able to

⁷⁷ See Hornick 2001 for further anecdotal evidence

have a provincial court block the seizure of its assets by foreign debt holders after defaulting in 1999, even though it had already received the full \$185 million. It has even gone so far as to sue the bondholders for previously paid coupon payments on the grounds of emotional duress over court proceedings. If this passes, a \$185 million dollar asset for the bondholders would be turned into a \$600 million liability⁷⁸. This is just one example, but this kind of ruling has been common as of late.

Domestic firms and debt holders have been equally mistreated by the judiciary system, which is making massive amounts of money due to its recent empowerment. Another business person put this more succinctly saying, “Stay out of the courts and settle everything you can personally. This is because 1) the judges are crazy, and 2) the law is worthless.” Because the dynamics of each decision is specific and not case specific I will not discuss further the dynamics of the judiciary. Rather, I will say that the last thing Indonesia wants in its current condition is a fully empowered and independent judiciary, at least not before a new effective authority exists, either democratic or authoritarian, to keep the judiciary inline. Even a dishonest authoritarian check is better than none.

⁷⁸ for further details and examples, see McLeod 2003

Chapter 4: Final Conclusions

Clifford Geertz in his book *Peddlers and Princes*, written before the period of economic modernization under Soeharto, asked what elements of traditional culture would need to be changed in order to facilitate economic take-off. In questioning the necessity of adopting the western form of modern government he stated:

To some extent at least, such studies suggest that the impact of economic modernization upon the total social system is not necessarily as revolutionary and all-embracing as it has sometimes been described; or, put somewhat differently, a modern economic system may be compatible with a wider range of non-economic cultural patterns and social structures than has often been thought.

The issue, properly stated however, is, not whether each and every aspect of society must change or nothing but the economy itself must change in the process of economic rationalization; for clearly neither of these extreme positions is defensible. Rather it is: What must change and what need not? And even to this question there is, as yet, no single, wholly general answer, for much depends upon precisely the sort of traditional system, which one is departing, and the sort of modern system one is attempting to create.

Clifford Geertz, *Peddlers and Princes* 1963

At its core, Indonesia's modern government has been a very traditional, Javanese style, rent seeking patrimonial hierarchy. Had Indonesia never grown since this article was written, it would be yet more proof that a country which does not conform to standards of modern Weberian bureaucracy or other form of legally based government, has difficulty growing. It is exactly because Indonesia has had one of the highest sustained growth rates in the world for 30 years while achieving economic and productivity gains within a government system which is clearly not legally bound and modern is what makes it a remarkable case. Indonesia provides an interesting example of how a well oiled centuries old "corrupt" patrimonial system, given the right checks and macro economic policy, can function for as long as single leader is in power.

But such a system holds the seeds to its own destruction as it can only last as long as the leader is at the helm. Without clear authoritarian organization, as is the

current case, the cultural tendency to empire build and seek bribes combined with very weak accountability and low official civil service wages almost guarantees anarchy to reign in the interim until the system can either successfully evolve into a modern legal democracy with a politically engaged middle class, or another short term solution can be found, which may very well be, another strongman.

The role of corruption in society completely depends on the form of government. If the government is organized around a patrimonial king figure, fighting corruption and destabilizing the political system in Indonesia during Soeharto's regime would not have been productive in the short term as it would have upset the most common means of property rights enforcement. Furthermore, long term benefits of anti corruption are not guaranteed in this context given that the counterfactual to the current system is not necessarily a functional democracy, considering that those in positions of political power to succeed him, in hindsight, did not offer a more effective and cleaner form of government. Habibie, Gusdur, and Megawati, the three presidents following Soeharto were not successful in changing the culturally rent seeking tendencies of the government and legal bureaucracy within a faulty democracy and inept authoritarian system. As traditional Indonesian presidential figures, they had no where near as much as Soeharto. And the fact that they were all convicted of their own corruption charges involving either themselves or like Soeharto, their direct family members⁷⁹ didn't help the democratic cause either.

⁷⁹ Megawati, though considered to be clean herself, was either oblivious or failed to take action against her husband Taufik Kiemas' multiple corruption scandals, one of which the author of this paper and his associates were on the undesirable end of.

But while under Soeharto, effectively going after and persecuting real corruption would probably have destabilized the system to the detriment of the economy, in Indonesia's current transitory state, fighting corruption may actually be good for the economy, though preferably only in the sectors where it would not further disrupt the political order and create general instability. Any democracy which emerges from Indonesia's current state is bound to have at least some corruption in the interim. The question is not if corruption should be fought, but which area of corruption it would be the most fruitful to take on. From the research presented in this paper, it should be clear that I suggest that the judiciary and tax collection system be targeted first. But fighting corruption then should not be a moral or democratic battle as it is often portrayed by anti corruption NGO's such as Transparency International or its local equivalents whose function is to name and shame corrupt individuals. Targeting and rejecting specific individuals in a corrupt environment on the basis of corruption may not have the desired affect as the counterfactual to the current corrupt individual is often someone equally corrupt but with less skill and experience. Nor would common recommendations from the international development community work, such as an empowered and independent judiciary. Another common recommendation is to provide training for bureaucrats so they can have more legitimate skills to take part in non-corrupt activities. In regards to the ministry of finance, this would be irrelevant. The ministry of finance is one of the best-educated and professional ministries in Indonesia. A source with personal contacts to the ministry of finance informs me that before a standard auditor had at least 3 years of private sector experience before joining up, and now the minimum is 5 years. Many individuals in the ministry of finance are even post doctorates. The anecdotal response I

got in regards to their high level of education was “they need to be smart to be able to extort you better. The smarter they are, the better they are at corrupting”. In regards to higher civil sector wages, no wages in the developing world would be able to match the bribe revenue of commercial judges in Indonesia.

So the question remains how do you fight corruption in such a corrupt environment. And this is where the patrimonial tendencies may be beneficial to the process. Reforms must be carried out to establish effective means of monitoring and punishing the judiciary and ministry of finance, and for Indonesia this would, ironically, necessitate a strong man (or woman) at the helm for at least some period of time to implement those reforms until an alternative form of government, possibly a functional democracy or another strong man, can be found.

Appendix: Summary of Research Data

The appendix reviews briefly the methodology of data collection, followed by a general summary of select interview findings.

Review of the Methodology

The research for this project was conducted over the summer and winter of 2004, as well as in early spring 2005. The data collection took the form of repeated interviews with senior managers and financial accountants in different industries who understood the inner workings of their own businesses as well as common industry wide practices through their association with trade associations and personal contacts. The companies interviewed were both local, foreign, and local- foreign joint venture. The industries of the companies interviewed are listed in the table below.

The interviews where corruption entered business operations and if it was an issue, and in what areas of their business corruption was most prevalent. This general overview also asked how larger political changes affected corruption, namely how corruption has been under new governments and administrative bodies. A second area of questioning also checked to see if corruption was a local versus foreign affair, *vis a vis* the FCPA logic discussed in Chapter 2 where corruption was believed to give a competitive advantage to firms from traditionally bribing countries, or local bribing firms over those from non bribing countries.

General Disclaimer and Limitations of Study

This study makes no claims to the viability of applying the dynamics discussed in this section to different countries or even time periods in Indonesia. This data is

supposed to represent current market conditions and dynamics, and though references are made to the previous regime, the applicability of this data is intended primarily for the assessment of the present time, and not the past. During the 8 month data collection period starting summer 2004 and ending spring 2005, there has been little observable change in corruption practices in regards to the period under the last few presidents since the fall of Soeharto. The democratic election of a new president, Susilo Bambang Yudhoyono, popularly known as a “clean” candidate, within the data collection period has slightly affected the corruption landscape. The new president has begun to crack downs on some corruption cases, the results of which have, anecdotally, made government officials in certain sectors more hesitant to push as aggressively for bribes following the presidential election. The effects of having a new “reformer” president are yet to be seen and have not visibly changed the fundamental dynamics of the government yet.

Secondly, the topic of corruption is extremely large and requires deeper analysis and in depth research to even determine aggregate effects of corruption on firm performance in Indonesia. In order to get the aggregate effects of corruption on economic development in general even just for individual industries would require a much larger data set than this study covers (That is, assuming one could exist). For this reason, the data reviewed in this section highlights business and industry dynamics and how corruption effects individual firms, and not the aggregate market effects of corruption on the economy.

Table 1: Industries Interviewed

<u>Industry</u>	Individuals Interviewed	Foreign or Local	# of companies
Real Estate Development	4	Both	2
Construction/ Infrastructure	2	JV	1
Retail, Distribution	3	Local	2
Hotel/Hospitality	2	Local	2
Manufacturing (Light, shoes)	3	Local	2
Manufacturing (Plywood)	3	Local	1
Agribusiness (livestock)	1	Foreign	1
Finance	1	Foreign	1

A General Summary from the Interviews

Before explaining further, it is important to note two things. First that, more than anything, the findings from the interviews underscored the difficulty inherent in pinning down the label of corruption on any single definable act, and following this, the difficulties inherent in categorizing corruption as a particular form of behavior or set of actions. Suffice to say, no two industries experience the same kind of corruption, and refer to different behaviors and situation as corrupt. Secondly, in regards to the most commonly studied form of corruption, that is public-private bribery for licenses and government services, the actual bribe costs themselves are surprisingly cheap, comprising

in most cases (where applicable) an anecdotal 1-4% of total costs (not including the more variable risks of tax and legal, which can be significant). As a result, The first finding is that a comparison between industries based on bribe payments or other comparable forms of measurement is somewhat irrelevant.

Being in Indonesia, currently Asia's most corrupt nation according to a survey of foreign investors, and given the local media's fixation on corruption and corruption related issues, all of the interviewees were for the most part aware of many publicized corruption headlines and scandals as well as popular notions of what seems corrupt and what is not. But despite the popularity of a more or less common anti corruption rhetoric, when it came down to describing corruption in their own fields, inconsistencies emerged between industries as well as within the same companies over what constituted corruption. Furthermore, the most common form of corrupt behavior studied in the literature, the transfer of bribes from mostly private sources to public officials in exchange for services or contracts, was for the most part irrelevant in day to day company operations to all of the industries surveyed, with the possible exception of plywood manufacture, and in that specific case, bribes paid a minimal role in the relationship between government officials and firms involved. The relationship was much more complex involving an official equity sharing agreement with a public government organization which, officially at least, was using its share of company funds for forestry and local development. Bribery from the plywood in the case of the company interviewed was to pay local police and officials to guard the concession against illegal logging. For other companies, bribery often takes the form of paying off regulatory officials (police, local government) in order to illegally log from other people's

concessions. It is unclear the overall effect of bribery in this case, though the mere technical difficulties inherent in guarding a million hectares of dense rainforest have led to weak monitoring and regulation and unsustainable cutting practices.

In general, public-private corruption is not even the main concern of all the businesses interviewed. When approached with the general question of “where does corruption enter your business operations and how damaging is it?”, most businesses, assuming the question was referring to any sort of corruption and not just public-private, answered that corruption *within* the company was the biggest concern with firm performance. For example, retail/distribution, hotel/hospitality, light manufacturing, agribusiness and (foreign) finance, government involvement beyond attaining basic licenses (the bribes for which turned out to be extremely cheap compared to the revenues they generated) was for the most part irrelevant. What these companies called their biggest problem with corruption was either suspected embezzlement from within the company and in many cases was simply managerial inefficiencies. In comparison, according to senior management asked, internal corruption and managerial inefficiency accounted for 15-30% of revenue loss for most companies interviewed, as opposed to the relatively paltry 1-4% of bribes to government officials.

Furthermore, when private firms are engaged in private practices with public officials, what determined corruption was not the action itself, but the fact that the client was the government and not another private firm. For example, in the hotel/hospitality industry, finance, construction, and all other industries which offer a service where the government, in addition to other private actors, can be a client, the same behaviors which are common or merely unethical with a private client, are considered corrupt with the

government. Examples include incurring high entertainment costs to get business (“wining and dining”) or offering “unregistered personal discounts” (i.e. kick backs). If the client were another private firm, the same behaviors would be considered highly questionable and immoral but not necessarily corrupt, or even against the law for that matter.

One concern arising from this is that the dominant anti corruption literature and the Washington Consensus Economics which justify it, as well as originally guided my line of questioning, pays scant attention to private sector only “corruption” simply because of it’s lack of government involvement. The case of Enron, WorldCom, Xerox and other US firms should highlight the much greater economic dangers of purely private sector corruption. Arguably though, anti corruption for private only corruption should not be a concern, because as one interviewee pointed out, there already is something which controls “in house-corruption” for most private sector firms: proficient managerial oversight combined with profit orientation. If private sector corruption is not in the interest of the firm’s bottom line or the owner’s or management’s interests, then standard accounting practices and managerial oversight should already be implemented to guard against kickbacks, embezzlement, stealing, over invoicing, and the hundreds of acts of malfeasance, which may or may not constitute corruption.

A Review of Public Private Corruption

Public Private Corruption is a standard facet of business in Indonesia, but even in Indonesia, for private sector non-state industries, it is still by no means the central facet

of business operations. Though that is not to say that it is not an issue if you handle the cultural relations and do everything legally. Tax and legal, as discussed in Chapter 3 are huge concerns for all the businesses listed, both foreign and local, and probably for the rest of the economy. But other than those two areas, the effects of government corruption on business is very uncertain because of the many different forms corruption can take and its long term implications in the case of firms which have repeated contact with the government. Under the Soeharto period, bribes to government officials were common, but the monetary value of bribes were not the primary issue, property rights were.

Property rights could be secured with bribes, but more often than not, property rights were often secured through non bribe means. Under Soeharto, this often took the form of foreign firms partnering and forming joint venture companies with members of the president's family, where in exchange for secure property rights, equity would be shared. But partnering with a family member of the Soeharto family was not the only way. Another option was to partner with a local firm (usually ethnic Chinese in origin) who would then be charged with the job of securing property rights, in addition to carrying out management and other various tasks. In that case, special measures are needed to secure property rights, such as having good relationships with government officials and if necessary, paying bribes though not in all cases. With the fall of Soeharto and the dissolution of some of his most powerful cronies (mostly large ethnic Chinese business groups as well), the option of partnering with the presidents family or his direct circle is no longer a viable option to fend off all individual rent seekers. Regardless, without a strong head, the same behaviors still exist, except with more actors. The kind of relations underlying public and private corruption are described below.

Preferential Treatment

One advantage to being in the government in Indonesia is the preferential treatment government officials get. In the case of the Hotel/Hospitality industry, the primary source of revenue generation in Jakarta is not tourist night stays but conferences or banquets. If an individual from a private company asks for a special discount on the cost of a conference package from the hotel which would not show up on the receipt (i.e. a kick back), the hotel manager can at his or her discretion choose whether or not to accept the discount on a market basis. Usually, to avoid potential complications the buyer can bargain for a better official corporate rate instead. In the same scenario, if a government agent asked for the same initial deal, the manager would be more inclined to accept the proposal, simply because he knows that the government agent is expecting it. The effect on the firm, besides complicity in a corrupt deal, which under the current legal system is not very relevant, is not very significant.

Historically this was even more so. According to people interviewed, under Soeharto, the ministry and bureaucrats were very strong. If the government sent a letter to a business asking them to participate in something (for example, a trade fair, or a project) the firm would have to do it. Now, the government is in general disempowered, but for the interim, such preferential treatment with government officials still exists, but to a lesser degree. The reasons for this arises in part because of residual power from the Soeharto era, but also partially for cultural reasons. Part of the rationale behind this treatment can be seen in the ambiguous area between bribes and gifts in Indonesia and many other Asian countries.

Bribery, Gifts, and “Good Human Relations”

In regards to what constitutes public private corruption, it is often difficult to discern the difference between a bribe and a gift. Such is the nature of the business culture in Indonesia that lavish gifts are given to those in positions of power, even if reciprocation is not guaranteed. This is of particular concern to the construction industry which must try to win tenders and contracts from government agents. In general, if you are dealing with the government in Indonesia, officials tend to ask for things. This is not necessarily money, but it can take the form of money. If an official asks for you to cover his sick mother’s hospital bill (an actual case), or to provide his son a middle level position in your company, or to fund his children’s education abroad, if you are in a position where you can provide that service, you are almost expected to provide it. At least such is the case for high-level large revenue tenders.

While corruption may exist with low level construction/infrastructural development, in multiple round public bidding, especially when an international development institution such as the World Bank or Asian Development Bank is one of the financiers, the bidding process is more or less transparent. (Whether corruption firms then skimp on the actual construction costs for private benefit though is another issue completely, the specificity of which is beyond the scope of this discussion) In this case, the lowest bidder will win, with very few exceptions, and therefore the benefit of giving money or in kind payments to an overseeing government official does not actually help win the bid. Nor is it likely that, under similar procedures, the same official can help

secure future projects for the private company. In response to why companies persist to give gifts, the construction executive answered, “This is for good human relations”⁸⁰.

“Good Human Relations” is cited as a common feature of many of the industries reviewed, namely developers, hospitality, and finance, and it helps in different ways for different industries. For construction firms and developers, government officials will give you information on how to do things, how to structure the project or tender to most easily get approval for project implementation, how to navigate the bureaucracy, and even inform you about other development opportunities or tender prospects. This information, per se, does not include the value of other bids by rival firms. Rather, it is information, which is publicly accessible. “The government people can tell you what you are missing” he continues.

At first glance, gifts to public officials in this sense can be considered *mzdoimstvo*, the Russian term introduced in Chapter 1, indicating a bribe paid to a public official to do something he is already supposed to do. But I would guard against such a simple understanding. The official does not have to go out of his way to assist a bidding firm with more information. And unlike *mzdoimstvo* which is most commonly used as “speed money” for petty government functions such as the provision of basic licenses or visas, bribe/gift transactions with government officials with whom you may have multiple contacts creates a very tangible relationship which is more than parasitic. This is also why it is not uncommon for city planners in charge of distributing licenses in Jakarta to quit the public sector and join private developers with which they have had

⁸⁰ Under any other situation I would have thought such an answer was an outright lie. But I am personally familiar enough with this individual and the practices of this company to accept this answer.

previous contact. And this does not only hold for real estate. Military officers who have used the armed forces at their disposal to help private concerns, for example by helping guard shipments in potentially unsafe territories or in helping secure plum deals with the government, are also commonly brought into businesses as managers for their previous help. Government ministers and presidential cabinet members are the same. This kind of relationship is common for all “successful” public sector officials in Indonesia. This behavior was also referred to as “Very Asian”⁸¹. Public-Private corruption then is not always as predatory and one sided for the firms involved as despite what the Washington consensus economic literature implies. But, it may seem as such to those who do not understand the local cultural ethic and are thus excluded from such opportunities, i.e. foreigners.

One example of what trust gets is flexibility. This flexibility may or may not be legal. An example of a legal case can be seen in the differences in how building tenders are processed by the World Bank or a multinational foreign firm, which are constrained by strict legal accountability requirements and a local private buyer or the local government. Normally in a strict bidding process construction companies must wait to win the tender, receive a letter of intent and down payment before starting work. This can delay ground breaking, increase legal transactions costs and opportunity costs of delay. A local company has the option of offering to break ground first before receiving the required paper work and down payment from the government, thus potentially increasing the risk of eventually not being paid, but increasing the firm’s chances of

⁸¹ For further published references, see Trust by Francis Fukuyama (1995). On a side note, despite this being an “Asian” feature of corruption, I have noticed that Dick Cheney shows the same behavior with his revolving door employment with Halliburton in the US.

being selected. Rules based firms cannot do this. Like corruption, informality alone has the possibility of cutting costs in an unregulated environment.

Conclusion in Brief

The findings from the interview research are inconclusive in determining the overall effects of corruption on firm performance. Mainly, this is due to the un-categorizeability of the effects of corruption within different industries and regulatory contexts as well as the overwhelming diversity of behaviors which can constitute corruption. The main reason for this may be based in the broad definition used for corruption in this study as well as the general definition for the rest of society. “Corruption” is too vague and all encompassing a concept to even use as a guiding framework for analysis. Rather, it may make more sense and provide better analytical results if ethical concerns were tossed to the winds and corrupt practices, in very specific contexts, were analyzed as any other business practice using existing managerial science theory. At least in that case, categorization would be possible, though comparability between different kinds of corruption would still be difficult.

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