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Economic policy and political culture in Indonesia

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Abstract

This paper analyzes the interface of economic policy and political culture in Indonesia. The paper explains how the institutions of Indonesian economic policy formation were an extension of a political regime that emerged after the 1965 demise of Suharto. That regime was largely politically non-competitive, which allowed the economic policy institutions to be used mercantilistically. The paper draws an analogy between mercantilism in Indonesia after 1965 and in England and France in the 18th century. © 2000 Elsevier Science B.V. All rights reserved.

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> Old soldiers in Indonesia neither die nor fade away: They do business. Some do it as a matter of self-preservation, others for a little more.
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> *Indonesia Business Weekly* (July 6, 1992)

1. Introduction

Until the recent collapse, the Indonesian economy had undergone more than a decade of remarkable growth. And, to a considerable extent, this achievement was

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rooted in sound macroeconomic management, investment in human capital, and a reorientation of the economy more toward the use of markets. But by the early 1990s, it was apparent that the quality of the growth was deteriorating and it is increasingly apparent that ‘‘crony capitalism’’ is substantially implicated in many of the questionable loans in the portfolios of the now defunct banks (Pomerleano, 1998; Cole and Slade, 1998). Beyond that, prominent among the IMF conditions for emergency finance are that some family and friends of former president Soeharto divest themselves of virtual economic empires in sectors devoid of legitimate competition (Johnson, 1998; Soesastro and Basri, 1998). That rent-seeking is afoot in the world is no surprise. However, it is nonetheless important to understand what sort of political culture creates a policy apparatus that rewards the rent-seeking, and so encourages it, in the first place. Also, we would presumably want to know what gives rise to such a political culture.

This paper addresses, in the context of Indonesia, the elements of political culture that encouraged and rewarded rent-seeking, well beyond the usual petty bribery sort, even as markets were being relied upon increasingly. The basic argument is that Soeharto eliminated political competition and that this in particular allowed for the creation of a mercantilistic economic environment akin to 16th century England and France. Macroeconomic stability and markets were embraced in order for the economy to grow so as not only to give the government legitimacy, but also to enlarge potential monopoly rents, which were then used to enrich strategically important allies and, eventually, family members. Furthermore, the system created a structure of incentives that encouraged more marginal rent-seeking schemes and led rent-seekers to misrepresent the quality of projects to potential lenders. A central argument of the paper is that political competition, had it been tolerated, would have substantially weakened the incentive and ability to pursue a mercantilistic strategy, and so the rent-seekers themselves would have formed a different perception of how to behave.

The argument has its intellectual roots in a recent paper on institutional change by Douglas North (1998), and so Section 2 briefly reviews North’s argument. Sections 3 and 4 then turn to Indonesia and recount the Soeharto era with respect to political culture and economic policy in light of North’s insights. Section 5 discusses the interface between political culture and economic policy and attempts to draw out some lessons through comparisons with French and English mercantilism as well as some contemporary country studies. Section 6 pursues the prospects for a change in the political culture and so a change in economic policy in post-Soeharto Indonesia. Section 7 offers some conclusions.

2. A theory of institutional change and incentives

North (1998) focuses on how institutions change and on how this affects economic policy and performance. He describes the process in five steps.