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The Arndt-Corden Division of Economics
Crawford School of Economics and Government
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Abstract

Attempts to maintain prices different from those that would otherwise be determined by supply and demand are virtually guaranteed to result in illegal behaviour, including in the case of laws that determine the salaries of civil servants. In Indonesia, private sector salaries are highly progressive with respect to increasing levels of responsibility, whereas the civil service structure is very flat, resulting in an enormous gap between private and public sector salaries at higher levels of management. As a consequence, informal—and often illegal—income generating practices are observed that make public sector careers far more attractive than formal remuneration levels would suggest. It is argued here that it is unhelpful to view endemic corruption simply in terms of unprincipled behaviour. Rather, it is best understood in terms of institutional weakness in the form of continued reliance on entrenched personnel management practices from the Soeharto era that deliberately ignored market realities.

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

JEL Classification: D72, D73, P16, P17

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State Law and the Law of Supply and Demand

Policy analysts in Indonesia are familiar with the formal hierarchy of various kinds of state laws. The Constitution is the highest law of the land, followed in turn by laws enacted by the parliament (DPR), government regulations, presidential decrees, and regional government regulations (Law No. 10/2004 on the Formulation of Laws, Article 7). But in reality another law outranks all of these, despite lacking any means of enforcement: namely, the economic law of supply and demand, according to which the prices of goods and services and assets adjust so as to bring supply into balance with demand. When governments create laws that are in conflict with the law of supply and demand, this inevitably generates illegal behaviour.

Examples abound. Since long ago, governments around the world have legislated against activities such as prostitution, gambling, and the consumption of recreational drugs, but have never succeeded in eliminating them: in each case, demand always finds sources of supply. At various times countries have tried to legislate their exchange rates, only to see a black market emerge in which both buyers and sellers are happy to do business. In the current Indonesian context, regulations that set fuel prices well below world market levels result in outward smuggling of fuels, and regulations that seek to prevent imports of rice result in inward smuggling of that commodity. In the labour market, the fixing of minimum wage rates above free market levels results in bribery of labour inspectors to turn a blind eye to infringements. In short, laws that attempt in some way to maintain prices different from those that would result from the unfettered interaction of supply and demand are virtually guaranteed to result in behaviour that is illegal in terms of those laws.

This same principle applies in the case of laws and regulations that determine the basic salaries of civil servants. The relevant law (Law No. 43/1999 on the Civil Service, Article 7) states simply that civil servants 'have the right to a fair and reasonable salary commensurate with their work and responsibilities'. While this aspect of the law cannot be faulted, the actual basic salaries set out in the related government regulations are deeply in conflict with the law of supply and demand. The individuals who comprise the civil service (and indeed the entire public sector workforce) supply services in return for remuneration, the 'fair and reasonable' level of which is indicated by the interaction of supply and demand in the private sector.[1] It can be expected that public sector salaries will be somewhat lower because of the much higher degree of job security, the promise of a pension after retirement, and the provision of a range of fringe benefits—not to mention the willingness of some individuals to sacrifice self interest in the service of the nation. The size of this gap in Indonesia, however, particularly at higher levels of management, vastly exceeds any realistic estimate of what is reasonable, as we shall see.

Similar to other cases in which state law conflicts with economic law, the consequence here is that public sector employees are bound to devote a significant part of their energies to finding ways to make their total incomes broadly comparable with what otherwise would be determined by the forces of supply and demand. Indeed, over the course of several decades, the civil service and other parts of the public sector have developed a variety of mechanisms to minimize the gap between private and public sector remuneration. In the specific case of the civil service, the most obvious of these is the proliferation of allowances (*tunjangan*) of various kinds. These include family allowances, rice allowances, structural allowances (for holders of managerial positions), functional allowances (for employees with certain professional skills), and so on; there is even an allowance for civil servants who for whatever reason do not receive structural or functional allowances (Presidential Regulation No. 12/2006). The purpose of all these allowances is to bring total remuneration levels closer to those of individuals in the private sector with similar qualifications and experience.

This effort still falls well short of what is required for higher level officials, however, even though the sum total of allowances far exceeds their basic salaries. Figure 1 compares managerial level remuneration in Indonesia's public and private sectors. The public sector data refer to the totals of basic salaries plus structural allowances at the senior upper levels of Echelons I-IV, which are assumed to be roughly equivalent to Chief Executive Officers, Directors, Senior Managers and Junior Managers, respectively, in the private sector. It can be seen that the gaps are enormous—and increasingly so, the higher the level of management responsibility. In other words, private sector salaries have a high degree of progressivity with respect to increasing levels of responsibility, whereas the civil service structure is very flat by comparison.[2]

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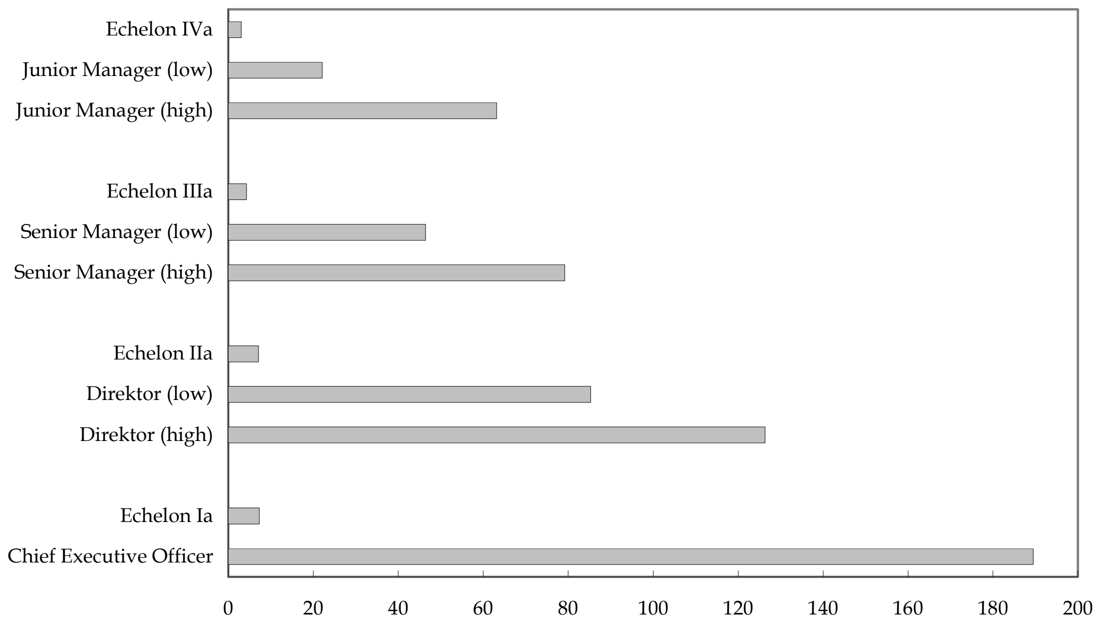
[1] The elucidation of the law interprets 'fair and reasonable' salary levels as those that avoid a gap between the welfare of public and private sector employees.

[2] By contrast, remuneration for new tertiary graduates to the civil service is much closer to private sector levels. Here the shortfall is of the order of 50%, but this gap would be partly offset by fringe benefits of various kinds.

FIGURE 1 Private and Public Sector Managerial Remuneration
(Rp million/month)



Source: Private sector remuneration data were taken from a report in *SWA Magazine*, February 15–28, 2007, of a survey by the Hay Group.

When the overall package of basic salary and formal allowances is clearly inferior to that available in the private sector, many government officials can be expected to react to the failure of their employer to pay them a 'fair and reasonable salary commensurate with their work and responsibilities' by finding ways to generate additional income from the opportunities that present themselves—including those that involve corruption. As a consequence, informal—and often illegal—practices have been introduced over the years, the effect of which is to make a public sector career far more attractive than formal remuneration levels would suggest. Many high level officials exploit these opportunities to the full, becoming extremely wealthy in the process. In short, governments' attempts to defy the law of supply and demand—both in their regulation of private sector activity, and in relation to remuneration of their own employees—result not only in patterns of illegal behaviour in the private sector, but also in the public sector itself.

The foregoing discussion suggests that it is unhelpful to view endemic corruption simply in terms of unprincipled behaviour on the part of the individuals who comprise the public sector workforce. A large proportion of these individuals see nothing wrong in their routine acceptance of additional payments that may be technically illegal, knowing that their formal entitlement to remuneration falls short of their private sector peers' incomes. At the same time, many members of the general public are usually not too concerned by the petty extortion they encounter in their dealings with the public sector. On the contrary, it is by no means unusual for them to make small gifts to officials they deal with from time to time—much like tipping waiters in restaurants—because they know that official remuneration is unrealistically low. Rather than being seen as individual impropriety, corruption is best understood in terms of institutional weakness. More specifically, it is a product of entrenched personnel management practices that ignore market realities. The main focus of the discussion that follows, therefore, is the central role played by these practices in the public sector during the Soeharto New Order era (1966–98).

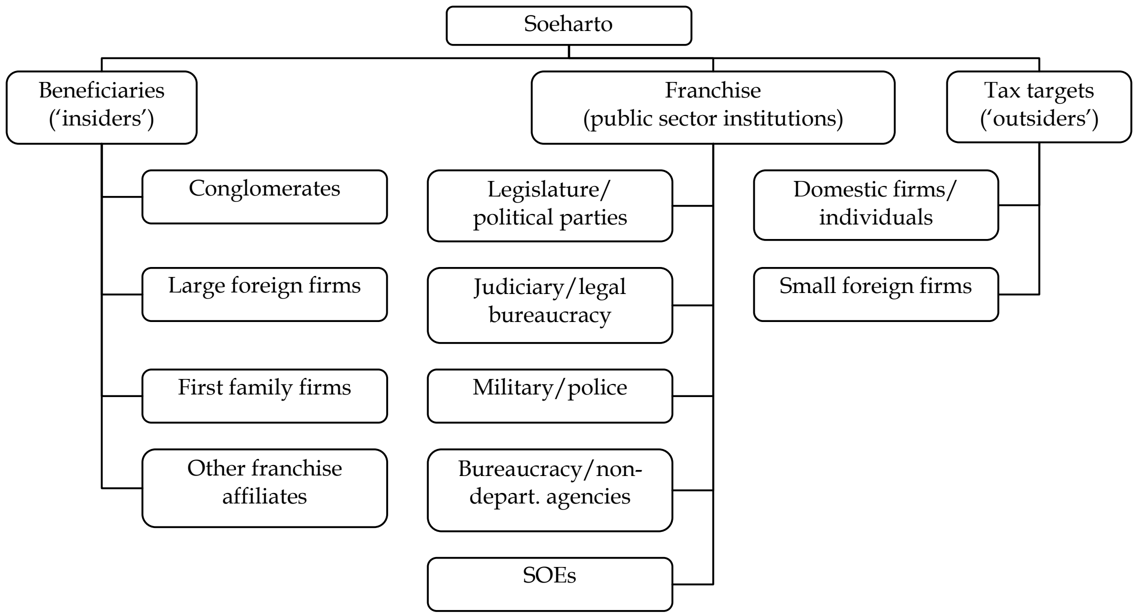
The Soeharto franchise

I argue that former president Soeharto moulded the five major components of the public sector into a 'franchise' system (Figure 2), the fundamental purpose of which was to use the coercive power of government privately to tax the general public and redistribute the revenue to a small elite. Government was not 'of the people, by the people and for the people', but rather 'of the people, by and for the controlling elite'. The discussion that follows provides a detailed interpretation of how this system came to operate under Soeharto. It is not intended to suggest that he came to the presidency armed with a full-fledged blueprint for this 'franchise', but rather that it evolved under his direction through a process of trial and error over a period of several years, and building on his own previous experience and observations of aspects of government both under the Dutch colonialists and under former President Soekarno.

The first branch of the franchise encompassed the legislature and the political parties. There were only three parties, one of which was Soeharto's election vehicle, Golkar. The other two were tame parties that had been formed by forced amalgamations of a greater number of parties that had existed in years gone by. The second branch of the franchise comprised most of the bureaucracy—that is, most ministries, plus a number of non-department agencies. The third element was the judiciary and the associated legal bureaucracy, such as the Attorney General's office and the Department of Justice. Fourth was the military, which, under Soeharto, also included the police.[3] Finally, we come to the numerous state-owned enterprises (SOEs) that were spread over a wide range of sectors of the economy, such as banking and finance, natural resources, transportation, retailing, plantation agriculture and so on.

[3] In recent years, the police force has been separated from the armed forces.

FIGURE 2 Soeharto's Franchise System



The core activity of this giant franchise was located in the bureaucracy and, to a lesser extent, the state enterprises. One of the key functions of the bureaucracy was to implement policies that would generate rents on behalf of the beneficiaries of the franchise system. These 'insider' beneficiary firms included the so-called 'conglomerates' (that is, large, diversified business groups owned by cronies of the president, most of which were owned by ethnic Chinese); a number of large foreign firms permitted to operate in Indonesia, almost always in partnership with some local entity favoured by the regime; companies owned by the first family (that is, relatives of the president himself);[4] and companies owned by franchisees (numerous officials at various levels within the public sector institutions) and their families. Rents could be generated in countless ways by the bureaucracy for each of these beneficiary groups. A simple example from the early days of the regime was the granting of exclusive rights to import cloves—the all-important special ingredient in Indonesia's famous clove cigarettes, or *kretek*—to just two firms, one owned by the president's half-brother, Probosutedjo, the other by one of his closest cronies, Liem Sioe Liong (Backman 1999:114). Another type of monopoly was that enjoyed by individuals—often serving or retired military officials—designated as

[4] This group became increasingly important and significant in the economy as Soeharto's children grew to become adults and began to establish businesses of their own, rather than in partnership with their father's cronies.

concessionaires with the sole right to undertake logging in large parts of Indonesia's vast rainforests (Barr 1998:4-6).[5]

Monopolies and concessions of one kind or another were just two of the means by which the beneficiaries of the franchise could be virtually guaranteed to earn very high profits, which were then to be shared with Soeharto and his family members, and with highly placed members of the franchise.[6] The state-owned enterprises were also used as a means of enriching the beneficiaries of the franchise system, most obviously the conglomerates and first-family companies. Firms in these groups engaged in business transactions with SOEs at artificially determined prices favourable to themselves. Loans from state banks carried below-market interest rates, and often had the enormous added benefit of not having to be repaid. Fuel could be purchased at below-market prices from the giant state oil company, Pertamina. Airport space and facilities could be rented from state-owned airport operators at below-market rates, again with the added bonus of perhaps indefinitely delayed payment.

The same kind of symbiotic relationship as that which existed between the president and big business was replicated on a smaller scale at ministerial level and below, as well as in regional governments throughout the country. Provincial governors, mayors and heads of districts, subdistricts and even villages, along with their bureaucrats and administrators, were encouraged—indeed, expected—to act in similar manner. When opportunities existed for government officials at any level to use their authority in ways that generated excess profits for favoured businesses, this was precisely what occurred. Obvious examples include awarding overpriced contracts for the construction of public works, government buildings and so on, or for the supply of equipment and materials to government offices, schools and healthcare facilities, and even for catering for official gatherings of one kind or another. Enterprises and banks owned by lower-level governments were also used to generate excess profits for favoured private sector businesses.

While insider firms harvested the rents generated for them by the bureaucracy, other 'outsider' private sector firms and individuals served instead as targets for predation. Franchisees within the bureaucracy, the military and police were expected by Soeharto to generate additional income via extortion from these firms and individuals, including smaller foreign firms, and to share the proceeds with

[5] These were monopolists in the sense that they were simply awarded concessions by government fiat, rather than needing to bid in competition with other firms for the right to log the concession areas.

[6] Two important techniques for rent sharing were donations by the insider firms to a number of non-transparent and non-taxable foundations controlled by the regime, and the issue of shares in these firms, free of charge, to family members of the franchisor and franchisees.

him. Bureaucratic extortion usually took the form of requiring bribes as a condition for the issue of licences, the delivery of normal public services, and so on, while extortion of a more overtly criminal nature, involving the use or threat of violence, was undertaken by the military,[7] often working through private sector sub-contractors—gangs of thugs known as *preman* (Wilson, 2006). The military also generated large amounts of income through involvement in victimless crime—gambling, prostitution and drug trafficking—and through illegal exploitation of the nation's natural resources, such as forests, minerals and fisheries (Rieffel and Pramodharwardani 2007).

The relationship of the public sector with outsiders was parasitic, while that with insiders was symbiotic. But in both cases it was the general public that ended up paying the 'tax'. The prices of products it purchased and of those purchased on its behalf by the government from the insider firms were artificially high; and the prices of goods and services sold to insider firms by state enterprises were artificially low. The payments made by individuals in response to bureaucratic, military and police extortion differed only in that they were quite transparent to the 'taxpayer'.

The 'product' offered by the Soeharto franchise was the right to make use of the coercive power of government to impose this 'private taxation' on the general public, whether by means of bureaucratic or conventional extortion, or by artificially boosting the profitability of insider firms at the expense of the general public (and then sharing the excess profit harvest with the beneficiary companies). The revenues collected were for the private benefit of individual members of the franchise and their subordinates and of the 'owner' of the franchise, Soeharto. In order to join the franchise or to move to a higher level within it—for example, by being appointed as a provincial governor or district head, or to a position of authority in one of the ministries, or to a court in one of the main commercial centres, or to a management position in one of the state enterprises—the individual was required to make a payment in some form, directly or indirectly (through higher-level franchisees) to the franchisor. This can best be considered as the upfront payment of a share of revenues expected to be received in the future by virtue of the exercise of the power to extort individuals and firms, or to generate and share in rents harvested by insider firms.[8]

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

[8] Note that whereas a large part of the early public choice literature (see, for example, Buchanan and Tullock 1962; Krueger 1974; Posner 1974) focuses on 'rent-seeking', the emphasis here is on 'rent generation and harvesting'.

Explaining success

By any measure, the Soeharto franchise was spectacularly successful in its objective of generating wealth for its members and cronies. Pre-crisis estimates of the net worth of the Soeharto family run to many billions of dollars, while cronies such as Liem Sioe Liong became among the richest individuals in Asia. Countless high-level bureaucrats, military officials, state enterprise managers and judges became fabulously wealthy relative to their miserably small official salaries. One of the keys to success was the fact that the regime was able to maintain a very high average annual rate of economic growth (well over 7% in real terms) over some three decades; very few countries in the world are able to boast a similar achievement. Of course, the regime collapsed in fairly spectacular fashion during the Asian financial crisis in 1998, and the economy plunged into a very deep recession. But although economic output fell by 13% in that year, conditions were able to be stabilized quite quickly after the regime change, and by 2000 the economy had returned to growth at annual rates of around 5%. Even taking into account this major setback, Soeharto left Indonesia's economy, and most of its people, considerably better off than they had been when he first came to power, notwithstanding the large-scale redistribution of income from the general public to the elite.

Elsewhere I have argued that the important distinction between Soeharto and most other developing country dictators is that he had an implicit understanding of the logic behind the so-called 'Laffer curve': that maximizing tax revenue (whether public or private tax) involves keeping the rate of taxation modest, since high tax rates have the effect of encouraging tax avoidance and evasion, or even driving the taxed activity out of existence (McLeod 2000:105–106). The Soeharto franchise owed its success to a strategy of imposing private taxation at relatively low rates on a very wide tax base—effectively the entire economy and its supporting natural resources. In other words, most kinds of economic activity were taxed in some way, but relatively lightly, so as not to destroy incentives for their continued expansion. The contrast with highly destructive dictatorial regimes such as those in developing countries like Nigeria and Zimbabwe, where private taxation was levied at high rates that took no account of their longer-term implications, could not be more stark.

Since the effectiveness of any organization depends on the behaviour of the individuals that comprise it, Soeharto's principal concern as 'owner' of the franchise was to create a set of incentives for individuals within it that would guarantee its success. An important concern of this chapter is to elaborate the nature of these incentives.

As is the case with commercial franchises in the world of business, the basic incentive to high performance on the part of franchisees is the monetary return this brings. Countless individuals were able to achieve huge increases in their net worth during their working careers by virtue of their success as Soeharto franchisees. The strong financial incentives they faced are clearly reflected in the fact that there have always been numerous applicants for positions in the civil service and the military relative to the number of such positions available at any time, and that individuals have always been willing to make under-the-counter payments to the relevant 'gatekeepers' to secure such positions, or to secure promotions and transfers to more lucrative positions once inside the system.

Another similarity with ordinary business franchises was the existence of a process of 'natural selection' that contributed to overall success. Individual performance relative to the objectives of the franchise was constantly monitored, and franchisees were continuously assigned and reassigned to positions that reflected their performance. The less successful franchisees found themselves shifted sideways as they were replaced by others willing to bid more for their positions, or who had persuaded officials at higher levels that they were capable of superior performance—and therefore of making greater financial and other contributions to the franchise—than those of the incumbents.

Public sector employees as threats to the regime

The Soeharto era version of the Law on the Civil Service (No. 8/1974) required individuals employed in the bureaucracy to sacrifice their own interests in the service of the state and their fellow citizens (Article 3). In reality, it seems unlikely that the prospect of a lifetime of self-sacrifice would have held much appeal to most public sector employees, who presumably hoped simply to earn a reasonable day's pay from an honest day's work—just like those who took up private sector employment. It also seems unlikely that public sector employees would have been happy with the notion of government as an instrument for redistributing income to the elite, however. One of the key problems Soeharto faced, therefore, was to ensure that civil servants would at least acquiesce in the face of common knowledge as to what the franchise was about, and certainly not actively oppose it.

A key part of the solution to the problem of ensuring loyalty to the franchise can be seen in Soeharto's approach to determining the structure of employee remuneration.[9] The 1974 Law required that salaries be determined bearing in mind the financial capacity of the state (Elucidation, Article 7), which provided a pretext for keeping them low. In fact, if they had been set at levels comparable with those in the private sector, the public sector could have been staffed perfectly adequately for the purpose of undertaking what are commonly regarded as the legitimate

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[9] For earlier discussions of the nature, structure and consequences of public sector employee remuneration, see, for example, Smith (1975); Gray (1979); and Clark and Oey-Gardiner (1991).

responsibilities of government.[10] However, this would surely have resulted in the recruitment of large numbers of individuals who would have baulked at the abuse of the powers of government that characterized the Soeharto regime. The franchise could hardly have been successful under such conditions.

Instead, the approach was to maintain a compensation structure that provided market-comparable incomes at the lower levels of the civil service (where opportunities for supplementing one's income were limited), but which kept earnings increasingly far below those for similarly qualified and experienced individuals in the private sector at the higher levels (where such opportunities were widespread). Thus, as we have already noted, the remuneration structure was greatly compressed: ratios of high-level to low-level incomes were much smaller than in large private sector organizations.

At first glance, this would appear to have made a career in the civil service thoroughly unattractive, except perhaps for those who did not aspire to promotions significantly beyond the lower ranks; and yet there were always far more applicants for civil service positions than there were jobs available. To some extent this could be explained by applicants having unrealistic perceptions as to the possibility of being recruited despite their limited educational achievements. The prospect of lifetime employment, a government pension beyond that, plus various other benefits such as subsidized family access to health services, free transport to the place of work and so on, was also important. More important, however, was the widespread and well founded perception that the income-earning potential of positions in the public sector was far greater than the pattern of formal remuneration and other benefits suggested. In other words, it was well known that one could expect to receive a wide range of additional allowances of one kind or another, and that if one were so inclined there would be ample opportunity to be involved in lucrative corrupt activity.

The history of the judiciary under the New Order clearly illustrates the key features of the Soeharto strategy for ensuring that most members of the franchise institutions would support the franchise, and that few would oppose it (Pompe 2005). The imposition of very low salaries relative to comparable private sector levels ensured that judges would be forced to play by the rules of the franchise if they were to enjoy a standard of living commensurate with their professional status. Members of the judiciary who were unwilling to do the bidding of the regime found themselves

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[10] Just as in the private sector, the socially optimal size of the bureaucracy is defined by the margins at which the gain to society from employing additional personnel just matches the cost of doing so, evaluated at market-determined salaries. Getting this balance right is a matter of adjusting numbers of employees, not salary levels.

languishing indefinitely in far distant outposts, with few fringe benefits, little work to occupy their time or hone their skills, and no hope for a 'successful' career in any sense of the term. At the other end of the spectrum, those who, like the president himself, enthusiastically embraced the notion of taking advantage of their positions to achieve personal enrichment, were only too willing to do what was asked of them by the regime. Among the latter, those who were most effective were appointed to highly lucrative positions in the most active big city district courts, and some were promoted to the high court or the supreme court.

With salaries and formal allowances kept low, public sector institutions needed only to be provided with limited funding from the budget to cover their personnel costs. The practical implication was that managers of these institutions had to find additional, off-budget sources of funds if they were to get things done and to provide additional income to their employees in order to secure their loyalty and support. Inevitably this would involve engagement in various forms of activity that were either clearly corrupt, or at least were located within the fuzzy boundary that delimits corrupt and non-corrupt activity. Thus, for example, despite the importance of the military's contribution to maintaining Soeharto's political monopoly,[11] on which the success of the franchise depended,

> the military won little in the way of budget resources during the Soeharto era. ... By withholding budget funds, [Soeharto] gave military commanders a strong incentive to engage in income-generating activities. At the same time, his ability to grant or deny access to these activities fostered a high degree of loyalty and dependence among these commanders. (Rieffel and Pramodhawardani 2007:32)

In other words, Soeharto secured the loyalty of the military not by allocating government revenue to it, but by appointing its commanders as franchisees—granting them the right to collect private tax revenues and to allocate them as they saw fit, including to their own pockets. The similarity with the case of the judiciary discussed above is obvious.

Within the bureaucracy, management would ordinarily devote part of the so-called 'development' budget, largely deriving from bilateral and multilateral aid agencies, to the payment of various allowances over and above the formal entitlements—for

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[11] The threat of military-sanctioned violence was not limited to the purpose of extortion, but also as a means of repressing potential opposition to the regime. The army had given a green light to the killing of hundreds of thousands of alleged communists and communist sympathizers as a prelude to Soeharto's appointment as president, and this served as a vivid reminder of the likely fate of any who dared too openly to criticize the New Order government. Discussion of these aspects of Soeharto's rule is beyond the scope of this paper, however.

example, to people who served on project committees (and, through them, to both their superiors and subordinates in the same area). More obviously corrupt was the practice of awarding government contracts at inflated prices to firms that agreed to kick back a suitably large portion of the excess over reasonable market value to the officials or committees that awarded the contracts. These illicit payments were typically used as slush funds for topping up the incomes of other employees of the government entity in question. The key point to note here is that the rents were shared widely within the relevant part of the bureaucracy. In this manner, large numbers of officials became dependent on the continued operation of the system. It was highly unlikely that any individual would blow the whistle on such practices, because to do so would be to put at risk not only a significant part of one's own overall income, but also that of one's peers. Lack of transparency within the system for transfers and promotions meant that such individuals could be severely punished by denying them promotion and access to informal allowances in cash and in kind to which they had no formal entitlement, or moving them to bureaucratic backwaters.

In short, the kind of salary structure chosen for public sector institutions was such as to discourage the entry of highly principled individuals (which is not to deny that many such were recruited, nevertheless), and correspondingly to encourage that of people who at least would not concern themselves too greatly about the sources of their special allowances and other salary supplements—or, better still, of those predisposed to engage actively in the work of the franchise. This is the only plausible explanation for the fact that individuals were willing to pay for the privilege of embarking on, and persevering with, a career characterized by increasingly large shortfalls below market salary levels the higher one rose in the hierarchy.

Decisions had to be made not only about the public sector salary structure, but also about the number of employees. Indonesia's civil service under Soeharto was never particularly large,[12] and yet, in relation to the fairly narrow objectives of the franchise, the number of public sector employees seems at first glance to have been unnecessarily great. This impression is no doubt heavily influenced by the obvious degree of underemployment within the bureaucracy, which was quickly apparent to visitors to virtually any government office building. Early in the New Order, Soeharto decided to adopt personnel management practices within the bureaucracy that mirrored those he had been used to in the army. One aspect of this was a rigid pyramidal hierarchy, in which the commanding officer would have a fixed number of subordinates reporting to him, each of whom would have a fixed number reporting to him, and so on down to the level of private. Thus all battalions, all

[12] In 1997 (Soeharto's last year in office), Indonesia had 4.1 million civil servants, equivalent to just 2% of the population.

regiments and so on would have the same number of individuals at each level in the hierarchy. Whatever its merits in the military context, such an approach made little sense within the bureaucracy, because different agencies were involved in widely varying activities, and their staffing needs differed correspondingly (Synnerstrom 2007:164–165). Nevertheless, the benefit to the franchise was that this approach typically resulted in excessive numbers of bureaucrats at low levels[13] and insufficient numbers of them at high levels. The rampant underemployment of staff just mentioned was in fact a characteristic only of low-level employees; by contrast, those at high levels were quite often heavily overworked. The implication was that relatively few at the low levels could expect rapid promotion, and yet promotion was the only way to gain access to the more lucrative opportunities for supplementing one's income with special allowances and other top-ups paid from slush funds or derived from participation in corrupt activity. In these circumstances, individuals desirous of promotion had strong incentives to compete with their peers—especially for promotion into positions in the 'wet' areas, where the availability of off-budget funds was greatest (Kristiansen and Ramli 2006).

Such competition took a variety of forms, and working hard was by no means the only one. The process for determining promotions and transfers within the bureaucracy lacked transparency and objectivity, and relations with one's own superior were, in practice, the crucially important deciding factor—hence the prevalent culture of *asal bapak senang*—'as long as the boss is happy'—within Indonesian public sector institutions. Management of franchises at the local level is typically delegated to the franchisee, who is then more or less free to choose which of his subordinates to promote or transfer to positions of greater authority, and which to leave where they are or to shift to positions of little influence. In the context of the Soeharto franchise, in which the primary objective was regressive redistribution of the national income rather than the delivery of services to the public, it is hardly surprising that competition also often took the form of bidding for desirable positions:

> In Indonesia, most civil service positions are for sale, rather than being acquired in open competition based on merit. The practice of selling civil service jobs goes hand in hand with corruption more generally—from one perspective, the investment needed to obtain a position needs to be recovered; from another, the likelihood of access to lucrative opportunities for self-enrichment makes such an investment worthwhile (Synnerstrom 2007:174).

The winners of the competition were those who bid the highest prices for promotion or appointment to particular positions, and these were typically those who had the

[13] The problem persists to this day, including at local government level (McLeod 2008:204).

greatest confidence in their ability to abuse these prospective positions of authority to generate cash inflows. That is, just as the salary structure encouraged recruitment of the kinds of individuals who would serve the franchise well, so the hierarchical structure within the bureaucracy reinforced this tendency by promoting the same kinds of individuals after they had had a chance to demonstrate their capacity and willingness to contribute to the objectives of the franchise.

There was perhaps one additional reason for recruiting what may seem like excessive numbers of high school and university graduates to the public sector.[14] The regime had decided to increase significantly the number of children and young people attending schools and universities, since this was clearly a way of generating support from the public and thus offsetting concerns that the government cared only about its big business friends. But students have always been a potent political force in Indonesia (Aspinall 2005: chapter 5), so it made sense to hold out the enticing prospect of a well remunerated career in the public sector following graduation, because students—and their parents—would have been well aware that involvement in student activism directed against the regime would very likely ruin any chance of being recruited. The strategy of offering eventual access to lucrative positions in the franchise to those who demonstrated their willingness to accept it for what it was thus extended even to *potential* public sector employees.

Allowing members of the bureaucracy and SOE branches of the franchise to tap into foreign aid flows and to collude with private sector firms engaged in economic transactions with the public sector constituted useful and effective means of allowing public sector employees to top up their formal remuneration and thus to ensure their support for the broad objectives of the franchise. But there were, of course, additional means of doing this. Recall here the distinction introduced earlier between insiders and outsiders. The insiders were the privileged firms that cooperated with the franchise so as indirectly to tax those outside the elite in one way or another. The outsider firms and individuals, on the other hand, were the targets rather than the beneficiaries of such taxation, and they were taxed by way of extortion (often known in Indonesian as *pungli*—*pungutan liar*—or unofficial imposts). Broadly speaking, the bureaucracy created a wide range of regulations with which firms needed to comply, and then found ways of forcing firms to pay bribes in order to obtain certification of such compliance. In addition, it accepted bribes from firms wishing to reduce, or avoid altogether, their payments of legitimate taxes, such as customs duties, value added tax and income tax. Outsider firms and individuals were also subject to extortion by the military and police, involving the employment of violence or the threat of violence to persuade them to

[14] In 1997, 83% of civil servants were graduates of senior high school or tertiary institutions.

contribute to their own ‘protection’. The small but relatively wealthy ethnic Chinese community was always particularly vulnerable, and some of its members found it prudent to try to keep local military officials favourably disposed to it (Susanto, 2006). But indigenous (*pribumi*) citizens were also targets.

It is because of the heavy emphasis on public sector extortion of firms and individuals that Indonesia has such a poor image in relation to corruption and bureaucratic inefficiency (Kaufmann, Kraay and Mastruzzi 2008; World Bank, 2008; see further discussion below). Indonesia’s rapid economic progress under Soeharto is somewhat paradoxical when viewed against this background. The paradox is readily resolved, however, when we recall the existence of insider firms, which collectively accounted for a very large share of the modern sector of the economy, and which were not only broadly immune to such extortion but in fact benefited strongly from their privileged relationship with the bureaucracy, the state enterprises and the public sector in general.

Post-Soeharto reform

The Asian financial crisis that began in mid-1997 suddenly created turmoil in Indonesia, depriving the New Order regime of its legitimacy as a sound economic manager. In turn, this simultaneously emboldened opponents of the regime and dramatically weakened Soeharto’s ability to maintain discipline within the franchise, such that its various branches and members no longer continued to act in a mutually supportive fashion. As a result, he was pushed out of office in May 1998, and reformers then moved quickly to overturn several key features of the regime he had built up over the previous three decades. Relatively little progress has been made in reforming the bureaucracy, however, which remains highly dysfunctional.

The law on the civil service was amended in 1999 so as to replace the previous naïve requirement for civil servants to sacrifice their own material well-being in the interests of the state and the people with a more realistic emphasis on the need for comparability of public sector remuneration with that in the private sector. This perfectly sensible restatement of principle has not been accompanied by an equally sensible restructuring of remuneration packages, however: as we have seen, these remain far removed from the realities of the private sector market for professional and managerial labour. Inevitably, the failure to remove the conflict between state law and economic law has meant that corrupt behaviour remains endemic in Indonesia’s public sector.

Surveys such as those undertaken by Transparency International suggest that Indonesia is one of the most corrupt countries in the world (ranked at equal 126th out of 180 countries in Transparency International’s Corruption Perceptions Index for

2008, with a score of just 2.6 on a scale of 1–10).[15] Other sources, such as the World Bank's *Governance Matters* and *Doing Business* reports (Kaufmann, Kraay and Mastruzzi 2008; World Bank, 2008) show clearly that it is also very inefficient, and emphasize the deleterious impact of this inefficiency on the business and investment environment. For example, Indonesia was ranked only in the 42nd percentile in terms of 'government effectiveness' in 2007 in the *Governance Matters* report.[16] At the same time, its world ranking on a number of important standardized indicators of the ease of doing business (as this relates to the influence of the bureaucracy) can also be seen to be very low (Table 1).

The bureaucracy succeeded in generating consistently high economic growth during the New Order period because this was in the interests of the franchise, and because there were strong incentives for success within it. The franchise prospered by taxing virtually the entire economy, so the faster the economy grew, the greater the pay-off. But in the entirely different context of post-Soeharto democratic Indonesia the bureaucracy as economic policy maker has been found wanting. The franchise no longer exists, since there is no longer a franchisor capable of imposing discipline on all of its branches: this became an impossibility once Soeharto's monopoly on the presidency came to an end. Its collapse following Soeharto's demise is directly analogous to the breakdown of a cartel as a result of its individual members' failure to restrict their output to agreed quotas: cartels cannot survive in the absence of internal discipline. In post-Soeharto Indonesia officials still have an incentive to abuse their authority to their own advantage, but they now do so in uncoordinated fashion, competing with each other rather than playing defined, mutually supportive roles within the giant organism that is the Indonesian public sector.

To the extent that current and future governments in Indonesia perceive government as an instrument for improving the efficiency of the economy rather than one for redistributing income in favour of sections of the elite, it seems clear that removing the conflict between state law and economic law is of crucial importance. This should not be interpreted to mean that merely improving the formal remuneration of public sector employees is all that is needed, however. Remuneration comparable with that in the private sector must be accompanied by other human resource management practices that are also comparable with those in the private sector. This should be taken to include a strong emphasis on performance evaluation as the key determinant of promotions (and therefore remuneration), and the opening up of vacant positions to competition among the widest possible range of applicants. In short, if individuals are to be paid market salaries, then they must also be obliged to

[15] See http://www.transparency.org.

[16] On this index, the lower the percentile rank, the less effective government is perceived to be.

compete on equal terms for positions within the public sector with all others who think themselves worthy of filling those positions.

TABLE 1 Ease of Doing Business in Indonesia:
Selected Sub-indices and Components

Indicator	Measure	Rank (among 181 countries)	
Overall ease of doing business			129
Starting a business			171
Time	76 days	165	
Cost (% of income per capita)	77.9%	146	
Employing workers			157
Difficulty of Hiring Index (0-100)	61	153	
Difficulty of Firing Index (0-100)	60	157	
Firing costs (weeks of wages)	108 weeks	168	
Paying taxes			116
Time	266 hours	103	
Registering property			107
Time	39 days	75	
Cost (% of property value)	10.7%	143	
Dealing with construction permits			80
Time	176 days	75	
Cost (% of income per capita)	221.1%	176	

Source: World Bank (2008).
Note: The closer the numerical rank to 1, the easier it is perceived to do business.

Conclusion

In this chapter, I have attempted to show how the Soeharto regime managed the economy and polity of Indonesia for the benefit of the dominant elite, rather than for Indonesian citizens in general. I have argued that his New Order 'franchise' was extraordinarily successful in terms of its own objectives, and that this reflected the strategies employed to provide appropriate incentives to individuals within the various branches of the public sector. Soeharto set total formal remuneration for more senior personnel very low relative to market levels. At the same time, however, franchisees were effectively granted the right to collect private taxation, backed by the full resources of the franchise. Positions as franchisees were thus eagerly sought after by those who had no qualms about using the coercive power of government for their personal benefit. Others who wanted nothing more than fair and reasonable—that is, private sector-comparable—remuneration were obliged to suppress their moral concerns about the functioning of the franchise unless they were prepared to be left to languish in positions where they would have no real influence on the processes of government, and where their earnings would be far below that of their private sector peers.

The conflict between the law on the civil service and the law of supply and demand resulted in a constant search by franchisees for ways to supplement their incomes, inevitably drawing them towards corrupt activity—thus making them dependent on, and unlikely to challenge, the status quo. Paradoxically, low salaries enabled Soeharto to buy support for the corrupt practices of his franchise. If significant progress is to be made in minimising corruption and improving the performance of the bureaucracy it will be essential to remove this conflict by more closely aligning remuneration and personnel management practices with those of the private sector.[17]

[17] While the present government of Susilo Bambang Yudhoyono does not see this as a priority, there is, nevertheless, a desire on the part of at least some members of his cabinet to move in this direction. Foremost among these is the Minister for Finance, Dr Sri Mulyani Indrawati; details of the far reaching bureaucratic reforms taking place in the finance ministry are discussed in McLeod (2008).

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