

# Doing Business in Indonesia: Legal and Bureaucratic Constraints

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**ABSTRACT:** The World Bank's new series of *Doing Business* reports attempt to measure the relative ease of doing business in countries around the world. The output of this research is a set of rankings that enable each country to see how it looks relative to the others from the point of view of private sector businesses. This paper highlights a number of concerns about the *Doing Business* methodology, and presents a critique of the 'law and finance' view regarding the influence of legal system origins on countries' economic performance, which was highly influential in the first of the *Doing Business* reports. Selected data from the 2006 report are used to explain why Indonesia is having difficulty getting back to Soeharto-era rates of economic growth. The report's findings in relation to Indonesia are then interpreted within the framework of an analysis of the way the Soeharto 'franchise' operated.

*Key words:* business regulation, contract enforcement, law and finance, legal heritage

*JEL Classification:* K2, K4, L51, P14, P52

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In 2004 the World Bank group identified the private sector in developing countries as the main driver of economic growth (World Bank 2004: viii):

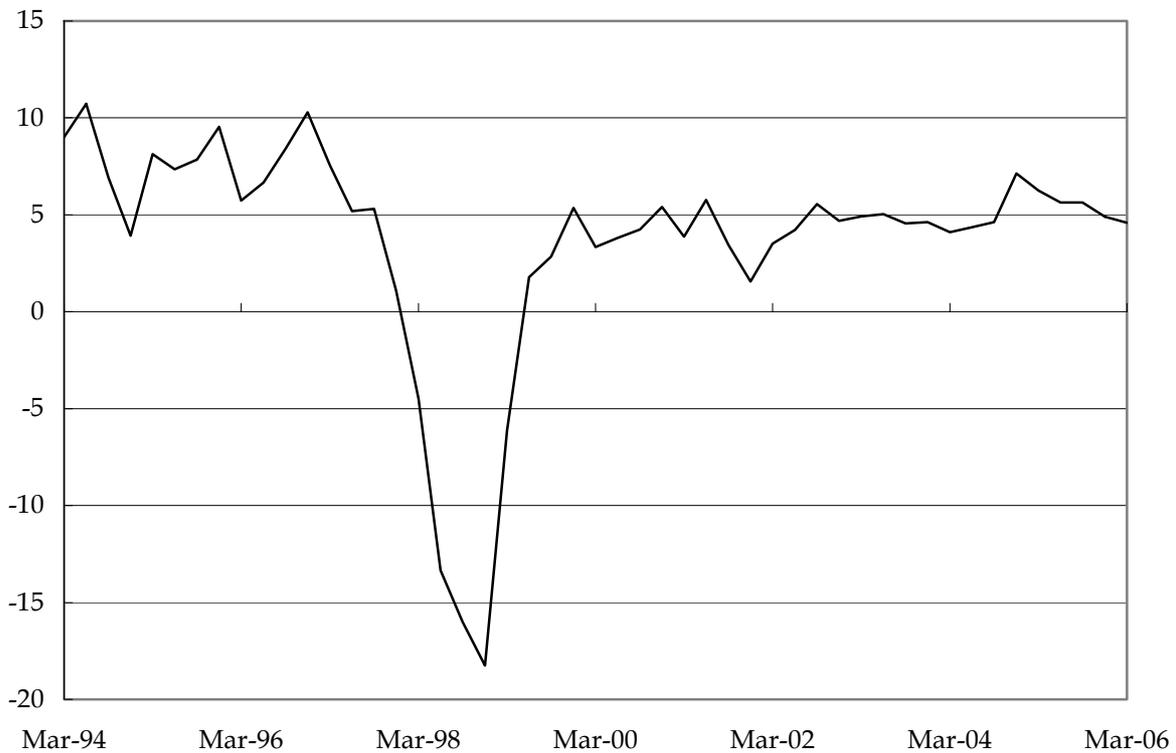
A vibrant private sector ... promotes growth and expands opportunities for poor people. To create one, governments around the world have implemented wide-ranging reforms, including macro-stabilization programs, price liberalization, privatization, and trade-barrier reductions.

Further, it recognised that the legal system and government regulation of business activity affect private sector performance to a significant extent:

Although macro policies are unquestionably important, there is a growing consensus that the quality of business regulation and the institutions that enforce it are a major determinant of prosperity... .

These observations introduced a very large and ongoing research project in this area, the results of which are being published in a series of annual reports under the general title '*Doing Business*'. *Doing Business in 2004: Understanding Regulation* was characterised as 'the first in a series of annual reports investigating the scope and manner of regulations that enhance business activity and those that constrain it' (World Bank 2004: viii).

**Figure 1 Indonesia's GDP Growth**  
(% p.a.)



These reports are potentially useful to the Indonesian government, as Indonesia's economic growth rates for the last several years have been significantly below those achieved prior to the Asian financial crisis of 1997-98 (Figure 1). Indeed, the present government of Susilo Bambang Yudhoyono ('SBY') was quick to pick up on the World Bank's assessment of the **Ease of Doing Business** in Indonesia in its latest report, in which Indonesia is ranked disappointingly at 115 in a total of 155 countries in the *Doing Business* database (World Bank 2006: Table A.1). This assessment sends a clear message that much needs to be done to improve the environment for private business activity if Indonesia is to return to its high pre-crisis growth rates.

But the difficulty of doing business in Indonesia is not restricted merely to getting an enterprise established in the first place. The overall Ease of Doing Business ranking is based on the country's ranking on no less than 10 sub-indices, as shown in Table 1.<sup>1</sup> It can be seen that Indonesia's performance relative to other countries varies quite

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<sup>1</sup> The procedure to calculate the overall index for each country is, first, to determine its average score for each of the sub-indices. Each such score is the country's position by decile in the ranking of all countries for that sub-index. For example, if the country is ranked 85 out of 155 countries, this would place it in the sixth decile, giving it a score of 6 for the sub-index in question. Once the averages are found, countries are then ranked on this basis.

widely across these sub-indices. It shows up in a fairly favourable light in relation to trading across borders, protecting investors, and getting credit, but less well on all the other measures. It performs especially poorly in relation to enforcing contracts, starting a business, hiring and firing workers, and closing a business.

Table 1 Ease of Doing Business in Indonesia

	Rank (among 155 countries)
<b>Ease of doing business</b>	<b>115</b>
Enforcing contracts	145
Starting a business	144
Hiring and firing workers	120
Paying taxes	118
Closing a business	116
Registering property	107
Dealing with licenses	107
Getting credit	63
Protecting investors	58
Trading across borders	49

A main objective of this paper is to try to explain what lies behind these data – that is, to look beyond the proximate causes of difficulties faced by private business for more fundamental explanations. Before attempting this task, however, it will be worthwhile to spend some time looking more carefully at the methodology applied in the *Doing Business* reports.

### **Comments on the *Doing Business* reports methodology**

The *Doing Business* reports are a huge undertaking, and a very useful initiative of the World Bank group. The attempt has been made to measure the relative ease of doing business in some 155 countries in an objective manner, using a standard methodology for all of them. The basic output of the research is a series of rankings that enable each country to see how it looks relative to the others. A low ranking in relation to a particular index provides a clear signal to policy makers that plenty of scope exists for improvement in that aspect of the business environment in their own country. Put simply, it should be difficult to ignore the fact that a procedure that takes many months in one's own country can be accomplished in a matter of days in many others. In the case of Indonesia, the present government is already making much of the fact that it takes 151 days to establish a new business there, by

comparison with only about 30 days on average around the world. The latter figure has become a target as the government seeks ways to improve the business environment.

Nevertheless, the *Doing Business* methodology is not free of defects, and it will no doubt be improved as researchers and policy makers become more familiar with it, and its shortcomings become more readily apparent. The database will become increasingly useful as these deficiencies are dealt with. With a view to contributing to this process, I turn now to discuss some of the flaws that have become apparent in the process of preparing this report.

#### *Distinguishing inputs and outcomes*

Of greatest concern is that some of the sub-indices, or their component measures, are focused on legal inputs—‘black letter law’—rather than actual outcomes. The undesirable consequence of this is that countries are ranked highly if their black letter law and institutional arrangements happen to conform to what the researchers consider to be sound, regardless of whether their performance is superior. What matters ultimately in relation to the **Protecting Investors** and **Getting Credit** sub-indices, for example, is whether the stock exchange is attractive to firms wanting to raise equity and to individuals wanting to invest; whether insolvencies are handled efficiently; whether there is an active market for loans; and so on. By contrast, the Protecting Investors sub-index ‘measures the strength of minority shareholder protections against misuse of corporate assets by directors for their personal gain’. Likewise, the Legal Rights component of the Getting Credit sub-index ‘measures the degree to which collateral and bankruptcy laws facilitate lending’, and the Credit Information component ‘measures the coverage, scope, quality and accessibility of credit information available through public and private credit registries’. All of these aspects reflect what the researchers consider to be good law and institutions, whereas what really matters is results achieved.

The focus on legal and institutional *inputs* in these cases is inconsistent with the entirely sensible focus on *outcomes* elsewhere (such as: how long does it take to obtain a licence? to enforce a contract? to establish a new business? how much does it cost to dismiss an employee?). This is indicative of a carryover of confused thinking from the so-called ‘Law and Finance’ literature, which focuses on the relationship between law and the operations of the finance sector (Beck and Levine 2003).<sup>2</sup> Focusing on legal inputs, Law and Finance researchers (e.g. La Porta *et al.*

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<sup>2</sup> This literature will be discussed in more detail below.

1998) felt that they could discern the difference between good and bad law across different jurisdictions in relation to the investor protections they offered to shareholders—as all the *Doing Business* reports now do. One particularly revealing example was the percentage of total company shares needing to be controlled by parties who wished to call an extraordinary meeting of the company, in relation to which it was argued that ‘the higher this percentage ... , the harder it is for minority shareholders to organize a meeting to challenge or oust the management’. The researchers set an arbitrary dividing line at 10%: that is, the country scored 1 (‘good’) if the owners of 10% or less of the shares could call such a meeting, but 0 (‘bad’) if more than 10% was required.

This became something of a problem in the La Porta *et al.* (1998) study, in which Delaware law was chosen as representative of the US as a whole—even though each state has its own company law—on the grounds that the tiny state of Delaware accounts for a hugely disproportionate number of incorporations. But Delaware does not legislate this particular matter, choosing instead to leave it up to the discretion of companies themselves. How, then, to rate the US on this measure: ‘good’ or ‘bad’? The researchers chose to use a 10% requirement as representative of the US ‘because the majority of U.S. states (27) use this number’ (La Porta *et al.* 1998: note 6), thus resulting in a score of 1 for the US on this aspect.<sup>3</sup>

An alternative response would have been to reconsider the view that this aspect of corporations law is important. The very fact that Delaware does *not* think so suggests the contrary. Some observers take quite the opposite view, however, arguing that Delaware’s dominance is precisely because companies legislation is most lax in this state, so that firms don’t need to worry too much about keeping their shareholders happy.

In my view, this argument is illogical.<sup>4</sup> Equity investment involves both demand and supply. Companies require capital, while individuals want to be able to invest their savings; the latter have thousands of companies to choose from (not to mention many other forms of investment). Companies simply could not succeed in attracting equity investors if they deliberately chose to incorporate in jurisdictions where shareholders routinely were treated badly—any more than they could by setting

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<sup>3</sup> It is probably no coincidence that 10% happens to be the cut-off level distinguishing ‘good’ from ‘bad’ law.

<sup>4</sup> It is akin to arguing that a monopolist can set any price it wants to, ignoring the fact that it is essential to take into account consumer demand for the product if profit is to be maximised.

unreasonably high issue prices for new shares. The overwhelming attractiveness of Delaware as a jurisdiction for the incorporation of companies constitutes very strong evidence that the legal environment in that state is regarded by players on both sides of the market, collectively, as superior to that available elsewhere in the US. When we focus on outcomes rather than legal inputs the issue becomes clear. A sound legal environment, by definition, is one that generates a high volume of the types of financial transactions in which we are interested—in this case, investment and trading in corporate equities—regardless of academic researchers’ evaluations of it.

This example illustrates the important point that although the Law and Finance researchers have quite strong views as to what constitutes good investor protection law, these views are often highly debatable. Consider the workings of equities markets, for example. Stock exchanges emerged historically as purely private sector initiatives, when it was realised that it would be useful to have an institution that could arrange for the listing of companies seeking to raise additional equity finance from individuals other than their founders. For a stock exchange to be profitable, potential shareholders needed to be reassured that it was a safe place to invest their savings, so it was in the interests of the exchange to set and to enforce rules of behaviour for companies’ managers and controlling shareholders.

The coercive power of the state did not need to be deployed here, since the exchanges could simply delist any company that failed to follow these rules, making it far more difficult for it to raise additional outside equity. If the exchanges had not drawn up and enforced rules to protect minority shareholders they would simply have failed in their objective of generating profits from the firms listing with them. Governments around the world have tended to incorporate the same kinds of minority shareholder protections in companies and securities legislation, of course, but it would be difficult to demonstrate empirically that this has had a significant positive impact on stock exchanges’ contributions to economic development. After all, the crucially important feature of stock markets—seemingly ignored in the Law and Finance literature—is that shareholders can readily divest themselves of shares in companies they suspect to be poorly managed, or managed to the advantage of controlling shareholders. This market-based form of protection seems to me to be vastly more effective and important than slow moving legal processes based on investor protection legislation. It can be argued, also, that there are more important uses for governments’ limited professional legal resources (especially in developing countries) than taking over an enforcement role that is capable of being played by the private sector.

Similar comments apply to most of the items on the list of factors considered in building up the Legal Rights component of the Getting Credit sub-index. For example, three of them involve questionable judgments about what is the best way to handle bankruptcy. Different countries do so in different ways, and it is not clear that any one approach is superior to others. The authors of the study appear implicitly to be of the opinion that the US process known as 'Chapter 11' bankruptcy is undesirable. In my understanding of this process, the firm in question is able to seek protection against its creditors and to keep its current management in place while it tries to work around the financial problems it faces. It should be recognised, however, that reliance on this approach is by no means inevitable: management must first convince a court that this will be in the interests of the relevant stakeholders. If it fails to do so, 'Chapter 7' bankruptcy procedures come into play, in which the firm is again protected against its creditors, but an administrator is appointed to manage the firm until it can be determined whether it would be better to keep the firm going, perhaps with a new injection of capital, or to liquidate its assets.

The *Doing Business* researchers, taking their cue from the Law and Finance literature, seem to regard the Chapter 11 approach (i.e. keeping current management in place, and protecting the firm against its creditors) as undesirable: they mark countries down if the law allows management to stay during reorganisation or if secured creditors are unable to seize their collateral. It is highly revealing that the US scores only 7 of a possible 10 points on this Legal Rights index, behind some 31 other countries that scored 8 points or more—including Bangladesh, Nigeria, Zimbabwe, Kenya and Albania. Presumably many economists and bankruptcy practitioners see considerable value in the Chapter 11 process, and it seems to me unhelpful, if not misleading, to include contentious items such as these in what purports to be an objective assessment of the relative ease of doing business in different countries.

The Credit Information component of the Getting Credit sub-index is also of questionable utility. The index depends crucially on the assumption that public and private credit registries should exist in all countries, regardless of their stage of development. Again, not all economists and financial institution practitioners would subscribe to this view. It is costly to operate an organisation that collects, collates and disseminates credit information on firms and individuals, and these costs may well exceed the benefits to banks and non-bank lending institutions, especially in relatively unsophisticated economies. If no private credit bureau exists in a country, the presumption should be that it has been judged unprofitable to establish one, not that the country lacks something it needs. And if no public credit registry exists, we

should perhaps congratulate the government in question for not wasting public money to support what should be a private, profit-oriented activity. In short, it is by no means clear that a country should be marked down because it lacks these kinds of institution. (Moreover, there is an element of double counting in the Credit Information index, because its third component is a score ranging from 0 to 6 based on various aspects of the information available through either public or private bureaus: if a country has neither of these, it will necessarily be given a score of zero on all three counts.<sup>5</sup>)

#### *Relative importance of sub-indices and their components*

Apart from these concerns about usefulness of the data that go into the overall index, questions can also be raised about how each sub-index contributes to the overall score, and how each component affects the relevant sub-index. This is basically a question about weighted averages. Each of the sub-indices is a simple average of the country's score on the component parts of those sub-indices and, as already noted, the overall index is a simple average of the country's score on each of the sub-indices. In other words, each component has an equal weighting in its own sub-index, and each sub-index has an equal weighting in the overall **Ease of Doing Business** measure. But the different sub-indices have different numbers of components, which implies that these individual components have different weightings in the overall index.

For example, the sub-index **Enforcing Contracts** has three components: the number of procedures involved in enforcing a standardised contract, the time taken to complete the entire process, and the total cost as a percentage of the debt in default. But the **Hiring and Firing Workers** sub-index has six components, each of which must therefore carry only half the weight of the Enforcing Contracts components in the overall index.

This is not necessarily 'wrong', but it is important to appreciate that there is an implicit assumption that each aspect of doing business that is considered important is considered *equally important* within its own sub-index, but *differentially important* in the overall index; insufficient consideration appears to have been given to this aspect. Different observers would very likely argue in favour of a set of weights quite different from the apparently fairly arbitrary weights implicit in the way the overall index is calculated, which means that the methodology employed in the

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<sup>5</sup> There is an element of double counting in relation to the Legal Rights measure also, since several of the aspects here also make an appearance in the Closing a Business sub-index.

*Doing Business* studies is by no means as highly objective as it may appear at first glance. On the contrary: subjective judgments about what is important play an important role.<sup>6</sup>

In relation to the Hiring and Firing Workers sub-index, as just noted, there are no less than six components. These include a hiring index, a firing index, a rigidity of hours index, and an overall rigidity of employment index—the latter being simply an average of the other three. The two other components are hiring costs and firing costs. Inclusion of the rigidity of employment index provides no additional information to the overall index (since it is simply an average of three other measures already included), but it necessarily reduces the weight given to hiring and firing costs. I argue, therefore, that the rigidity of employment index should not be included in determining the value of this sub-index.

In relation to the **Paying Taxes** sub-index, I argue that it is unnecessary to focus on the total number of taxes paid. Increasing the number of taxes is only a problem if it increases the cost of compliance for a given total amount of revenue. But there is already a direct measure of the hours devoted to tax compliance. If this total cost is unchanged, an increase in the number of taxes is irrelevant to the ease of doing business. Moreover, inclusion of a component that measures the total amount of tax payable (as a percentage of gross profit) is very dubious. The dissipation of profits in tax payments is of course a problem for the individual firm, but on the other hand governments need tax revenues, and if taxes on business are reduced then other kinds of taxes would be needed to replace them. These new taxes could well turn out to be more distorting than the taxes they replace. Alternatively, if total tax revenue falls as a result, there will be consequences for the delivery of government services, including the provision of infrastructure and a sound legal system, for example, which would be harmful for firms. My suggestion in relation to this sub-index, therefore, would be to drop the two components other than the measure of compliance costs.

### *Summary*

In summary, my recommendation would be that two of the sub-indices (Protecting Investors, and Getting Credit) should be dropped altogether, and that certain components of some of the sub-indices also should be dropped. On the other hand, it should be noted that a number of other important constraints on doing business

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<sup>6</sup> I have already given some examples of measures that should be assigned a zero, or at least a very low, weight, in my opinion.

have been neglected entirely in the *Doing Business* reports to date. These include inadequate infrastructure (especially transport infrastructure), and unreliable utilities (in particular, electricity and water supply, waste disposal systems, and telecommunications services). Another aspect that needs to be considered is the difficulty of doing business in an environment in which businesses are routinely extorted—perhaps by organised crime and petty criminals, but also even by the military and the police. All of these aspects are of undoubted importance in at least some countries, including Indonesia. It is to be hoped that the World Bank will try to design measures of these aspects of obstacles to doing business for inclusion in its future reports.

### **Doing business in Indonesia: a closer look**

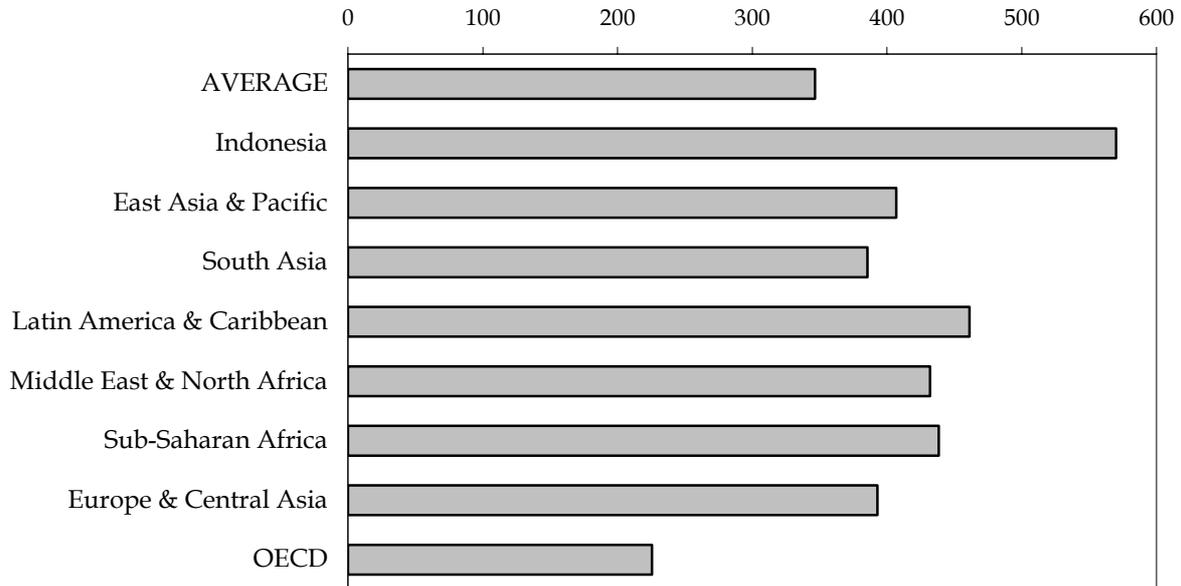
With these reservations about the *Doing Business* report methodology in mind, we turn now to look more closely at the 2006 findings in relation to Indonesia. Table 2 focuses in more detail on the **Ease of Doing Business** index, omitting several sub-indices and sub-index components in line with the preceding discussion. The sub-indices are presented in two groups: those that involve the judiciary, and those that involve the bureaucracy. There are only two sub-indices in the former category, namely: Enforcement of Contracts, and Closing a Business. In relation to the former, Indonesia scores extremely badly, as already noted: 145<sup>th</sup> among the total 155 countries.

The *Doing Business* researchers have looked carefully at the long list of procedural steps necessary to enforce a (standardised) contract in Indonesia. There are some 34 steps involved in the process (some of which can take place simultaneously with, or could be included in, others). In this regard Indonesia is not much different from the sample average of 31.5 steps, and it ranks 99 on this measure. However, in relation to the things that really matter to the plaintiff—namely, the time involved to complete the process and the overall cost—Indonesia fares very poorly, with rankings of 134 and 151, respectively (Figures 2a and 2b). Indeed, Indonesia is one of only nine countries for which the cost (126.5% of the debt involved) actually exceeds the debt. The process takes no less than 570 days (i.e. over 18 months). Small wonder, then, that private sector entities in Indonesia largely avoid using the courts for contract enforcement—relying instead on other means of protecting their interests, such as the use of private debt collectors, or simply being very careful in their choice of people to do business with.

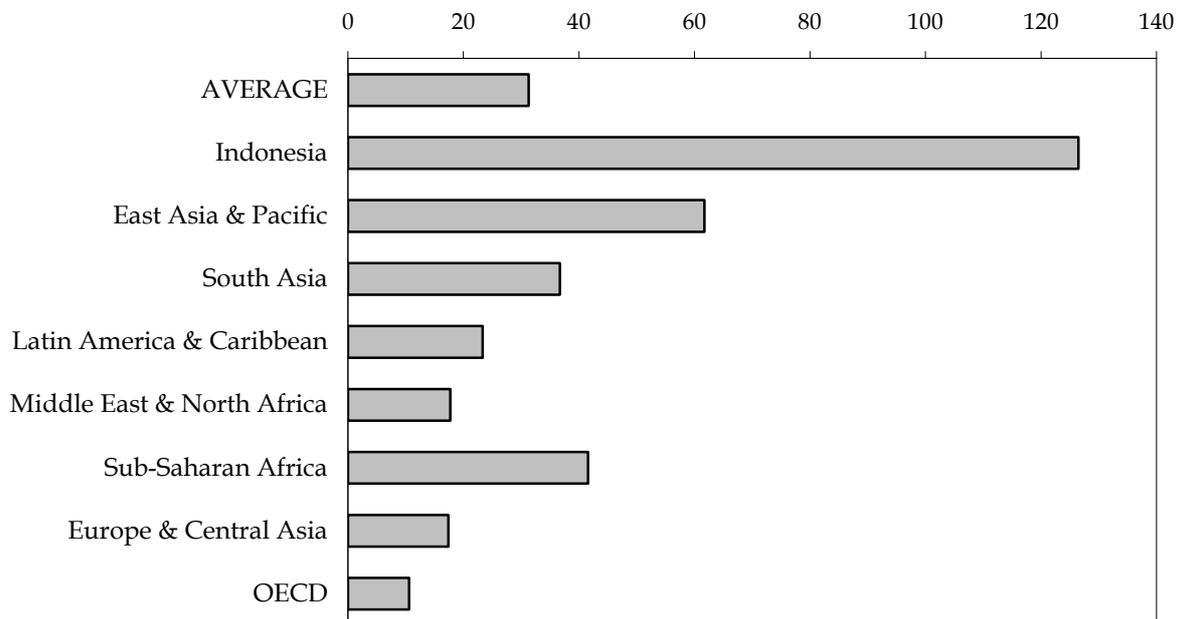
Table 2 Ease of Doing Business in Indonesia: Selected Sub-indices and Components

	Indicator	Rank <u>(among 155 countries)</u>
<b>Ease of doing business</b>		<b>115</b>
<i>Matters relying heavily on the courts</i>		
Enforcing contracts		145
Time	570 days	134
Cost (% of debt)	126.5%	151
Closing a business		116
Time	5.5 years	133
Cost (% of estate)	18.0%	99
Recovery rate (% of amount owed)	13.1%	119
<i>Matters involving the bureaucracy</i>		
Starting a business		144
Time	151 days	149
Cost (% of income per capita)	101.7%	121
Hiring and firing workers		120
Difficulty of Hiring Index (0-100)	61	122
Rigidity of Hours Index (0-100)	40	63
Difficulty of Firing Index (0-100)	70	131
Hiring cost (% of salary)	10.2%	53
Firing costs (weeks of wages)	144.8 weeks	150
Paying taxes		118
Time	560 hours	119
Registering property		107
Time	42 days	60
Cost (% of property value)	11.0%	126
Dealing with licenses		107
Time	224 days	98
Cost (% of income per capita)	364.9%	104
Trading across borders		49
Time for export	25 days	62
Time for import	30 days	64

**Figure 2a Time to Enforce Contracts**  
(days)



**Figure 2b Cost of Enforcing Contracts**  
(% of debt)



The second sub-index in this category relates to the ease of Closing a Business. This focuses on bankruptcy law, and the main procedural and administrative bottlenecks in the bankruptcy process. Here, we focus again on what matters most to the failed firm's creditors: the time involved to complete the process, the recovery rate (i.e. the amount recovered as a percentage of the amount owed), and the cost involved (as a

percentage of the bankrupt estate). In terms of the costs involved, at 18% of the bankrupt estate Indonesia is somewhat higher than average but, surprisingly, significantly lower than in East Asia and the Pacific as a whole; its ranking on this measure is 99. In relation to this component, however, note that the costs only include court costs plus the fees of insolvency practitioners, independent assessors, lawyers, accountants and the like, but do not include bribes. This makes the measure very difficult to interpret in the Indonesian context.

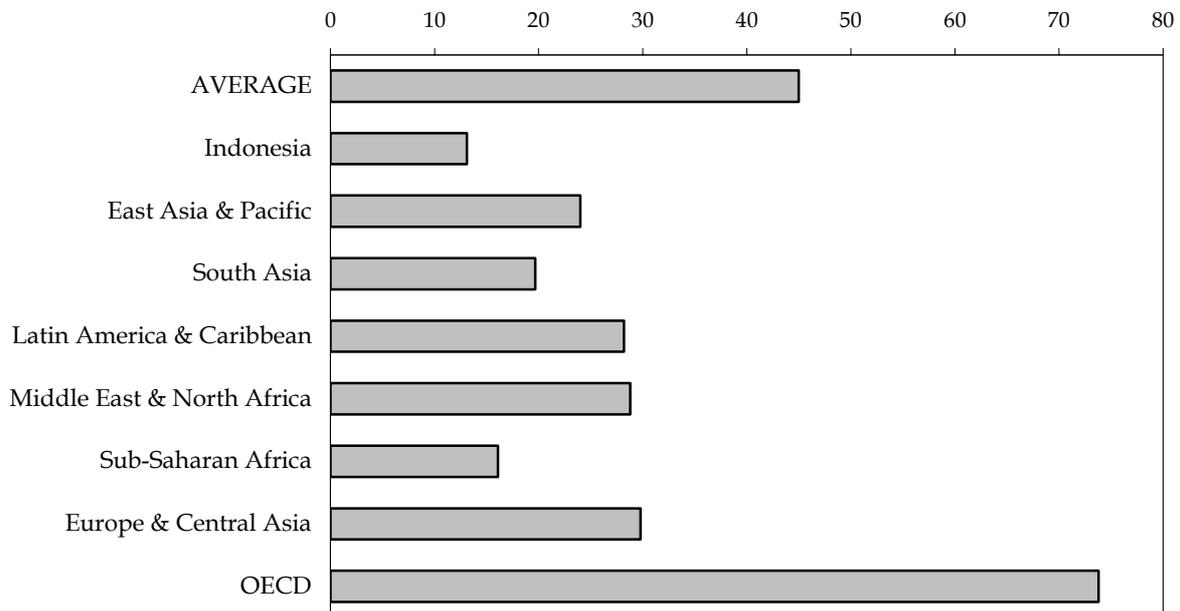
As in many other fields involving the public sector in Indonesia, the formal, nominal costs or fees involved are set very low precisely in order to make it possible to extract correspondingly high bribes from the entities involved. By way of explanation, if the amount of debt in default is, say, \$10,000, then this amount provides the upper bound for the extraction of bribes. If court costs and fees are quite high relative to this amount, then judges and court officials will find it difficult to extract any bribes. In the limiting case, if these costs amounted to \$10,000, then the plaintiff would have no incentive whatsoever to pay a bribe, as winning the case would yield no net gain.

For these reasons it seems more helpful to focus on the recovery rate, which, at just 13.1%, is far below the world average and less than every regional grouping—including Sub-Saharan Africa—resulting in a ranking of 119: in other words, only 36 other countries perform worse on this measure (Figure 3). One of the main reasons why Indonesia's recovery rate is so poor is that the bankruptcy process takes far too long—some 5.5 years. Over such a long period, interest foregone on the amount of the unpaid debt becomes quite large, physical assets deteriorate, and there is the possibility that other assets are stolen or otherwise shifted beyond reach of creditors. In short, the *Doing Business* report leaves us in no doubt that the Indonesian legal system is highly defective, in so far as its ability to resolve cases of bankruptcy is concerned.

We turn now to the second, much larger group of sub-indices: those that involve the bureaucracy. These sub-indices relate mainly to aspects of private sector business operations that are heavily dependent on the issue of permits, licences, statements, approvals and so on by the bureaucracy and, to a small extent, by the police. We begin by looking at the most important component of the Starting a Business sub-index: the time taken to establish a (standardised) new business.

The time taken to start a business in Indonesia is 151 days. Entrepreneurs wanting to establish a business in the form of a legal entity are obliged to deal with slow moving bureaucrats at the Department of Justice and Human Rights, the local

**Figure 3 Recovery Rate when Closing a Business**  
(%)



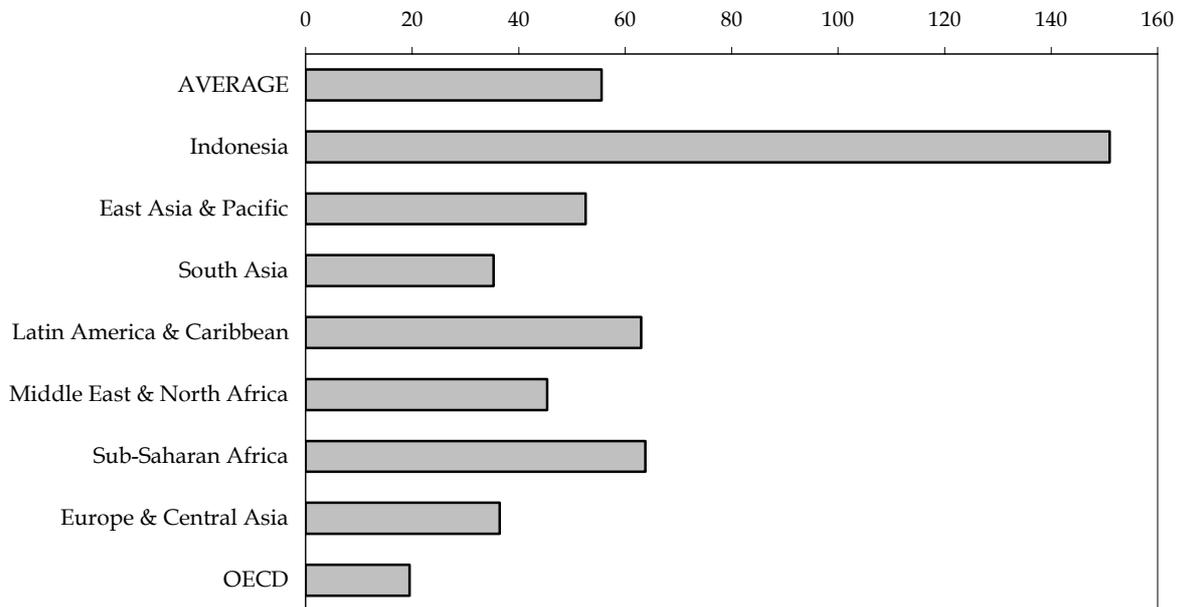
municipality, the tax office, the Department of Industry, the Department of Manpower, the state-owned Social Security institution, the police, and even the state printing company. By contrast, it is possible in a small number of countries to establish a business within the space of a week, and the average for the entire sample is just 56 days. The Indonesian figure is far higher than that in any of the regional groupings, and compares very poorly with only 20 days in the OECD. Indonesia ranks at 149 on this measure (Figure 4).

Another area where bureaucratic intervention detracts strongly from the ease of doing business in Indonesia is the labour market. A previous government succeeded in pushing legislation through the parliament that has had the effect of making this market very rigid. Minimum wages have been imposed and steadily increased—thus reducing firms’ incentive to recruit workers of relatively low productivity. There are now also requirements for extraordinarily large severance payouts when workers lose their jobs—thus giving firms a strong incentive to be highly selective in recruiting workers if there is any suggestion that they may either leave, or need to be dismissed, after only a short time. Strangely, the World Bank study gives very little weight to minimum wages,<sup>7</sup> which are certainly of great concern to the business

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<sup>7</sup> As mentioned above, there are six components of this sub-index, and minimum wage data account for only one-third of one of these. Thus minimum wage policy has a weight of only 1/3 times 1/6 in this sub-index, which itself accounts for only 1/10 of the overall Ease of Doing Business index. In

**Figure 4 Starting a Business**  
(days)



community. The database contains information on minimum wages relative to average value added per worker, but unfortunately it does not seem feasible to compare this measure with that for other countries. The study does focus on other areas of rigidity, however: in particular, in relation to the difficulty of firing workers and to the size of required redundancy payments.

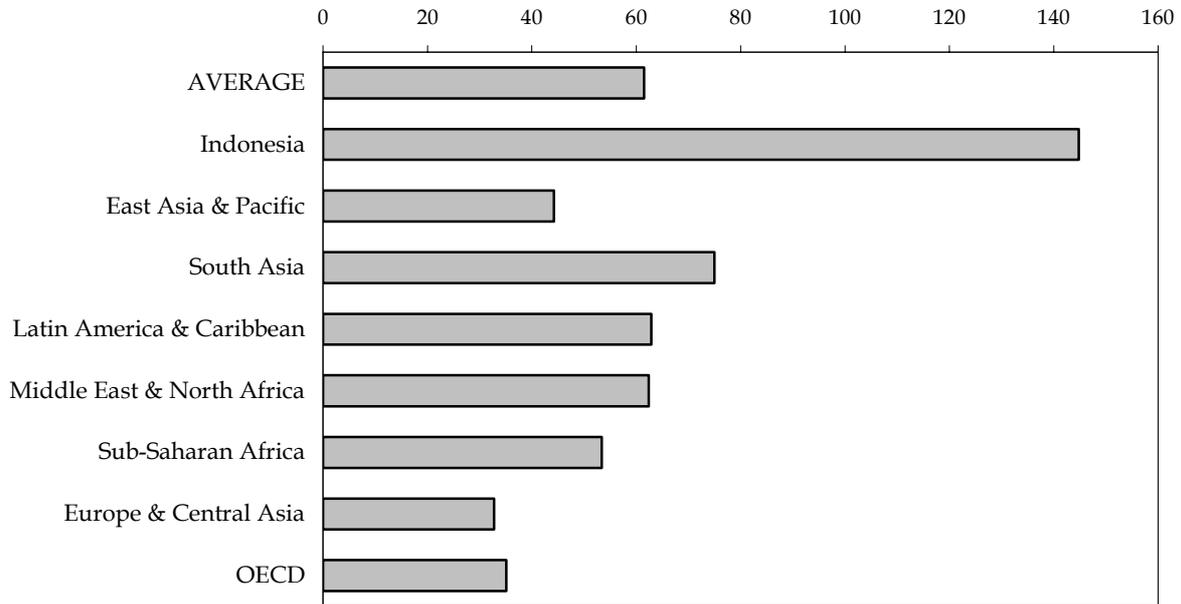
Within the Hiring and Firing Workers sub-index, Indonesia is close to the average for the Rigidity of Hours index, but it is far above average in relation to the indices of difficulty of hiring, and difficulty of firing. Its rankings on these two measures are 122 and 131, respectively. It is in relation to firing costs where Indonesia looks extremely bad by world standards: these amount to 144.8 weeks of wages, compared with only about 14 on average for all countries in the sample, and Indonesia's rank on this measure is only 5 from the bottom, at 150 (Figure 5).

In relation to the Paying Taxes sub-index, I focus purely on the time cost of tax compliance, for reasons outlined above. Again Indonesia compares very unfavourably with the rest of the world. The time devoted to tax compliance is far higher than the world average, and nearly three times as high as in the OECD countries; Indonesia's rank here is 119 (Figure 6). Similar findings apply to the

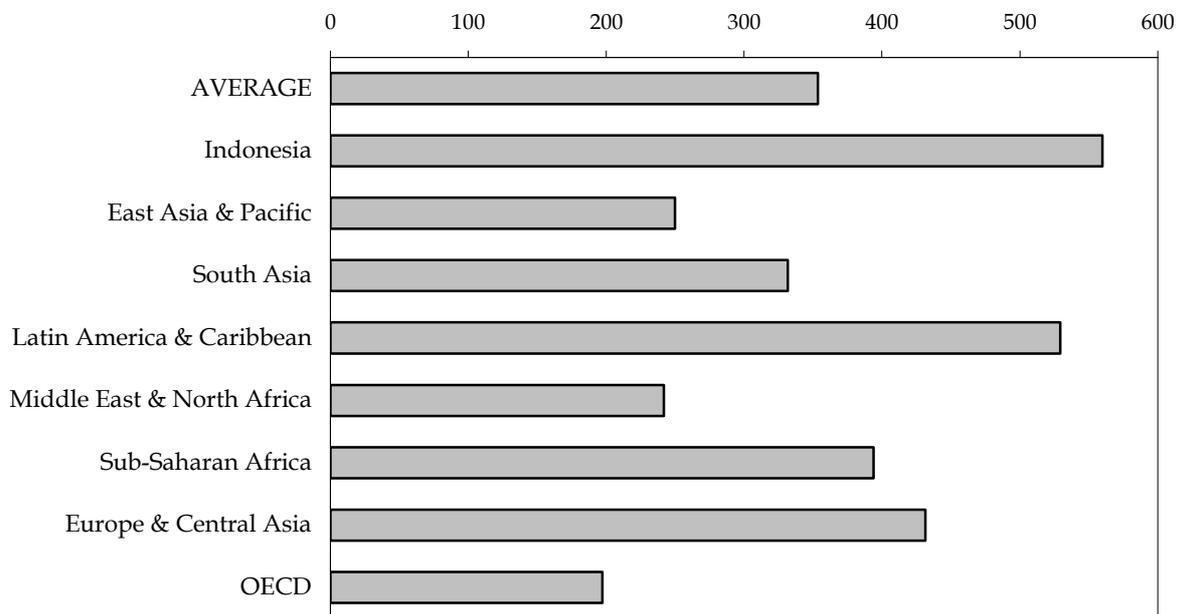
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other words, minimum wages are given a weight of just 1/180 in the overall index. I feel fairly confident that most businessmen would give it considerably more weight than this!

**Figure 5 Firing Costs**  
(weeks of wages)



**Figure 6 Paying Taxes**  
(hours)

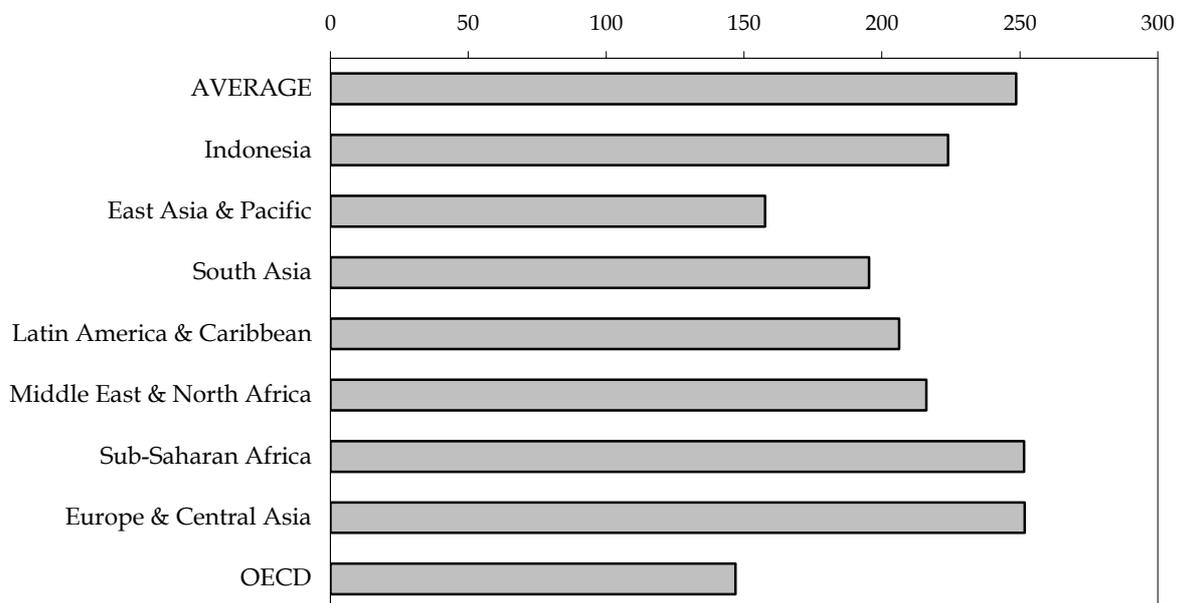


Registering Property and Dealing with Licences sub-indices. Indonesia performs reasonably well in terms of the number of days required to register a (standardised) land and building package (42), which is significantly less than the average of 85.6 days, and somewhat better than for the East Asia and Pacific region as a whole; its ranking here is 60. When we look at the cost involved, however, we find that this is

as high as 11% of the value of the property; on this measure Indonesia ranks far lower, at 126.

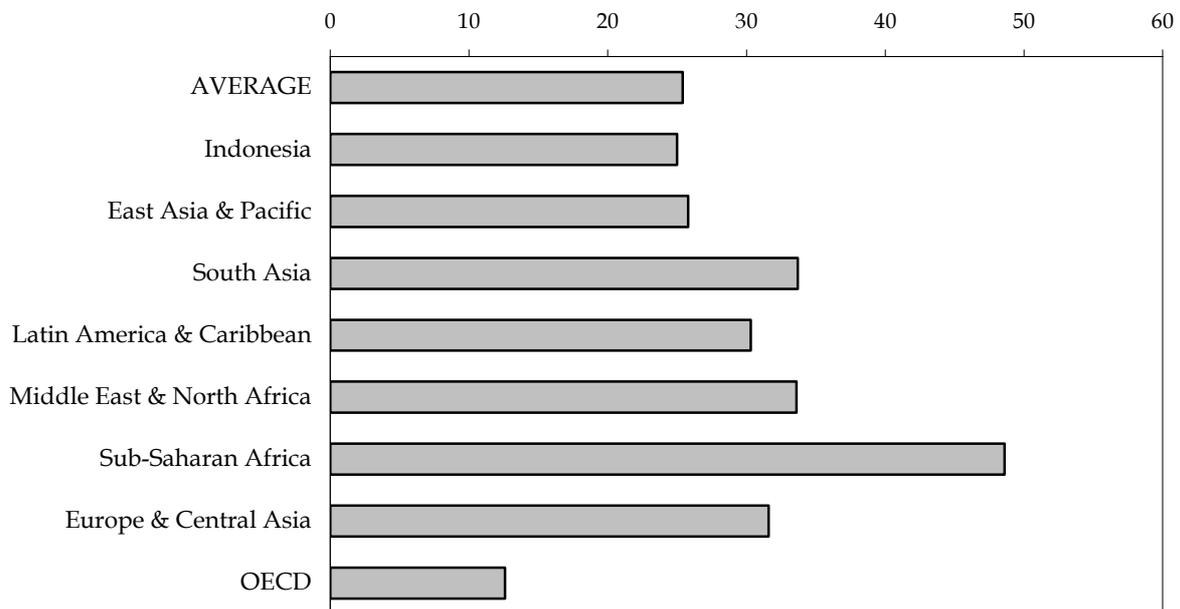
Licences are required for a vast array of purposes, and the *Doing Business* reports attempt to allow for this by focusing on the bureaucratic procedures involved in building a (standardised) warehouse in each country. To obtain this licence in Indonesia takes 224 days (i.e. more than 7 months), which is a little less than the country average; Indonesia ranks 98 in this regard (Figure 7). In terms of cost, equivalent to 364.9% of per capita national income, it ranks 104.

**Figure 7 Obtaining a License**  
(days)



Only in relation to the last of this set of sub-indices – Trading Across Borders – can it be said that Indonesian performance is within the top half of the country rankings. For brevity I focus here mainly on the time need to complete standardised export and import shipments: 25 days and 30 days, respectively, earning Indonesia rankings of 62 and 64. The time to make an export shipment is almost exactly the same as the sample average, although still considerably longer than for the OECD countries (Figure 8). The same is true for completing an import shipment. In relation to the numbers of documents and signatures required for the standardised export shipment, somewhat surprisingly Indonesia requires a little less by way of documentation and considerably less by way of signatures than for the sample average; again, similar comments apply in relation to import activity.

**Figure 8 Time to Make an Export Shipment**  
(days)



We now have a somewhat clearer idea of the difficulties faced by firms trying to do business in Indonesia. Although we cannot be sure of the precise impact of dropping the Protecting Investors and Getting Credit sub-indices (and dropping certain components of other sub-indices), the effect is surely to reduce Indonesia's overall ranking even further in relation to the Ease of Doing Business, since it scores rather well in relation to Protecting Investors and Getting Credit. In other words, it is clearly the case that Indonesia ranks even worse than 115 as a desirable place to business when we focus on a more appropriate set of measures, and that the operations of the judiciary and, to an even greater extent, the bureaucracy, are holding back private sector activity. We turn now to look for explanations of these findings in Indonesia's recent political history.

### **Soeharto's franchise system of government**

The business environment in today's Indonesia is very much a reflection of the legacy of former president Soeharto, who ruled the country largely unchallenged for more than three decades from 1966 until May 1998, at which time the rapid unravelling of the economy and economic policy-making as a result of the Asian financial crisis forced him to step down. For this reason we begin with an exposition of the nature of the regime he built up over this period.

Soeharto created incentives for effective government—in the sense of government that delivered sustained and rapid economic growth, and significant poverty

reduction—within what I have described elsewhere as a public sector ‘franchise’ system (McLeod 2000a, 2000b, 2005). The conventional business franchise concept is that all franchisees act in concert, on the understanding that there are greater profits to be earned as part of a single organisation selling exactly similar products and services than as stand alone units competing with each other and with other firms. To this end, rules of membership are set out and enforced for the mutual benefit of franchisor and franchisee. Franchisees usually have to pay what amounts to a ‘joining fee’ and to make periodic contributions to the franchisor, in return for the financial benefits of membership.

The Soeharto franchise was similar in principle to this simple business model, but a great deal more complex in its operations. A more descriptive, if cumbersome, title would be ‘multi-branch, multi-level franchise’ (Figure 9). The branches of the franchise included the legislature (MPR, DPR<sup>8</sup> and tame political parties); the judiciary and the legal bureaucracy; the military/police; the bureaucracy (including non-department agencies, especially the logistics agency, Bulog, and the central bank, Bank Indonesia); and the state-owned enterprises, especially the state banks and the giant oil company, Pertamina. Most of the branches encompassed a number of levels. Legislatures existed at national, provincial and district/municipality levels, while the bureaucracy extended right down to the villages. The hierarchy of the judiciary extended down from the Supreme Court through the High Court to the district courts. The army also had regional divisions, as did the state banks. Other aspects of the franchise in Figure 9 will be discussed shortly.

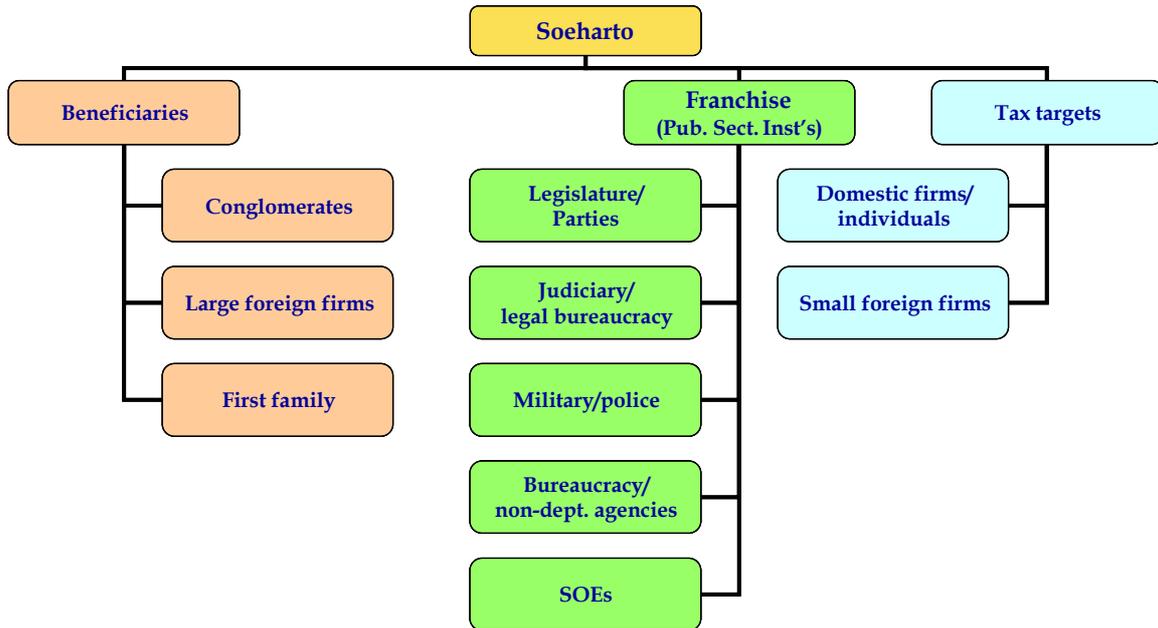
The objective of the Soeharto franchise was to keep its ‘owner’ in office indefinitely, and to harness the coercive power of government to the goal of continuing enrichment of the president, his family, and his business cronies. It was designed to provide strong positive and negative incentives to ensure its success. Key public sector officials could rapidly become wealthy if they joined the franchise and lived by its rules, but they could find themselves sidelined, imprisoned or worse if they failed to perform well or if they worked against it. It prospered by means of ‘private taxation’—that is, by collecting various forms of informal taxation from individuals and firms.

The ‘taxes’ imposed by franchisees consisted of two main types: extortion by bureaucratic, judicial and physical means, and rents generated by the bureaucracy

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<sup>8</sup> The MPR is the (now defunct) People’s Consultative Assembly; the DPR is the People’s Representative Council (or House of Representatives).

Figure 9 Soeharto's Franchise System



through its economic policies and harvested by cronies of the regime (the 'conglomerates'), members of the first family, and large foreign firms. These three groups were the major outside beneficiaries of the system, and they shared the rents with their patrons within the franchise itself in return for the favours they were given. By and large, this taxation was levied at a low rate on a wide 'tax base' that comprised a large part of the economy as a whole, in conjunction with economic policies that helped the private sector to generate rapid economic growth in order that the tax base would also grow rapidly. Thus there was a close correspondence between the interests of Soeharto's franchise and the interests of the general public, notwithstanding the fact that the effect of private taxation was to redistribute some income and wealth from the weak to the strong: both the franchise and the public stood to gain from broadly sound economic policies that generated rapid growth.

Within this franchise system, the basic role of the legislature was merely to help maintain the fiction that Indonesia was a democracy. In reality, only three political parties were allowed to exist, and the system was rigged in various ways so that only one of them – the ruling Golkar party – had any chance of 'winning' elections. Golkar always maintained a majority of seats in the DPR, while the armed forces – another branch of the franchise – had a number of parliamentary seats reserved for their appointees. The MPR, which consisted of equal numbers of DPR members and other non-elected members appointed by the president, had very little to do other than to elect a president at five yearly intervals. In such a system it is hardly

surprising that Soeharto had no opponent each time he ran for office. Members of parliament had virtually no impact on the legislative process nor in holding the government to account in the interests of the Indonesian public. But they were well rewarded for playing out their role as loyal members of the franchise.

The military played a much more active role. It was given the freedom to engage in all kinds of business, legitimate and otherwise—including gambling, prostitution and drugs. Officers loyal to Soeharto could expect rapid promotion, appointment to a well remunerated position in a state enterprise, the grant of a valuable timber concession, or some such. In return, the military could be relied upon to deal forcibly with individuals and organisations that posed any kind of the threat to the franchise. In similar fashion, the judiciary was expected to use the more subtle, if no less coercive, power of the courts to deal with other threats. The main payoff for its members came by way of being permitted, in effect, to charge the individuals and firms that came before the courts for decisions in their favour. State enterprises served a number of purposes: providing sinecures to military officers and retired bureaucrats, channelling cheap loans to cronies and first family businesses, purchasing goods and services from, or selling them to, favoured firms at advantageous prices, providing jobs for family members of individuals who assisted the franchise, and so on.

But at the heart of the franchise stood the bureaucracy, the key role of which was to create rents that could be harvested by business interests friendly to the regime. In the search for sources of rents—new components of the private tax base—few areas escaped unscathed. The range of rent generation techniques included the following:

*Protection from imports.* In conjunction with licensing to constrain domestic competition, favoured firms were granted protection from imports.

*Awarding contracts without bidding.* Favoured private sector firms were awarded contracts by government departments and state enterprises without any genuine bidding in competition with other firms.

*Providing access to cheap loans.* Favoured firms had ready access to state bank or even central bank loans at highly subsidised interest rates—and were not forced to repay if investments did not turn out well.<sup>9</sup>

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<sup>9</sup> In the course of the 1997–98 crisis it became clear that the state banks were responsible for by far the bulk of bad loans (Pardede, 1999: 26), a large proportion of which were owed by Soeharto family and crony companies (*Dow Jones Newswires*, 15 June 1999).

*Granting rights to exploit natural resources.* The award of rights to exploit natural resources without having to bid or to pay a reasonable level of royalties has been of immense benefit to associates of the franchise. Forest concessions are the most obvious example.

*Rights to take over land.* The grant of rights to take over land, in practice without payment of fair compensation to the original occupiers, has been a method often used to generate rents. This has occurred with land around major cities, and also with tracts of forest to be converted into plantations.

*Purchase of inputs at artificially low prices.* In many cases firms have been favoured by being permitted to purchase inputs at artificially low prices from state enterprises – if they were paid for at all.

*Sale of outputs at artificially high prices.* Similarly, firms have been favoured by contracts that allowed them to sell their output at artificially high prices to state enterprises and government departments. Electricity generation is a prime example.

*Favourable treatment by the tax office.* The business sector has always been able to reduce the amount of legitimate tax it paid through negotiation of mutually beneficial outcomes with Soeharto franchisees in the tax office. In addition, at various times the Soeharto government made tax holidays available to firms it wanted to favour.

*Rights to collect taxes.* In the later years of the Soeharto regime, the rent generation effort at times became so blatant as to encompass the imposition of new taxes collected by first family companies – a small portion of which was supposedly turned over to the government.

For ‘insider’ firms that were the beneficiaries of the system there were plenty of ways to share rents with their patrons within the franchise. Very often the approach was to issue shares in the enterprise to the franchise collaborator or a relative, free of charge. Alternatively, large payments were made to tax-exempt, non-transparent foundations (*yayasan*) controlled by the president or his close associates. At a lower level of sophistication, payoffs could take the form of bundles of cash stuffed into envelopes or briefcases.

All of the above techniques were intended to benefit the insider firms in question, together with their franchise collaborators. Far from making life difficult for this part of the business sector, the intention was to create significant benefits for it. For countless other firms and individuals, however, the picture was as depicted in the

*Doing Business* reports: rather than assisting these 'outsiders', the bureaucracy, the military and the judiciary used their positions of power to extort them in countless ways. The explanation for this is that when high level officials are abusing the system in various ways for their own benefit there needs to be some means of avoiding opposition from their subordinates—or, better still, of ensuring their support. The simple solution to this problem was to bring lower level officials and staff of the bureaucracy into the franchise as well. This was done mainly by allowing them, also, to abuse their positions so as to boost their incomes.

One means of doing so was to allow the payment of all kinds of special allowances: for attending meetings; for travelling to other cities or overseas; for being members of organising committees, especially those involved with procurement; and so on. In addition, and of greater relevance here, the bureaucracy has proven adept at creating countless regulations that require some kind of bureaucratic action before private sector firms can carry out their normal business activities: the issue of licences, approvals, certificates, permits and so on, and even the provision of receipts for legally required payments. The explicit or implicit threat of delay in taking such actions inevitably forces the private sector entity to consider whether it may be less costly to offer a bribe. So effective and widespread is this approach that most people take it for granted that it will be necessary for them to offer some 'grease money' if they are not to be blocked by the bureaucracy in whatever it is they are trying to do.

We have already discussed the heavy bureaucratic burden faced by entrepreneurs wishing to incorporate a new business. At every step along the way, the official in question can find a reason why the necessary signature cannot be given yet: the relevant forms have not been filled in properly; the signed forms on which they depend are defective in some way; the necessary statements don't say quite the right thing; the person who has to sign off is not available at the moment; and so on. All of this is merely a charade, and each player knows that all such problems can be overcome with a minimum of delay by an appropriate payment. Likewise, police on traffic duty find it easy to extort payments from individuals for minor traffic infringements. Nobody wants the bother of being charged and having to appear in court: indeed, if a driver were to insist upon this course of action the policeman would be very likely confiscate the car keys so as to so inconvenience the driver that he would immediately come good with the requisite bribe.

Such processes are so entrenched in Indonesia that private firms exist for the sole purpose of serving as a middleman in the business of bribery. It is their job to know which bureaucrats have to be paid, and how much, in order to get the relevant processes finalised. One of my own memories as a student researcher in the late

1970s was waiting in the office of a temporarily unavailable Immigration Department bureaucrat, watching one of these private sector middlemen come in with a handful of passports, sit at the bureaucrat's desk, and stamp all the passports ready for the bureaucrat to sign. Clearly, the arrangements between these two individuals were well bedded down.

It is this phenomenon that explains a large part of the findings of the *Doing Business* reports. Except for insider firms, it was difficult doing business in Indonesia during the Soeharto regime, precisely because the bureaucracy and the judiciary had a strong incentive to *make* it difficult: their own incomes depended on them doing so. By keeping official salaries at low levels the regime could ensure that those who joined the civil service would need to become involved in at least marginally corrupt behaviour if they were to enjoy a reasonable standard of living, thus making them complicit in the operations of the franchise and giving them an interest in its continued existence.<sup>10</sup> To the extent there has been any change since Soeharto stepped down it has been a change for the worse. Whereas there was previously a strong, single franchisor who insisted that franchisees kept the total level of private taxation within reasonable bounds, the last several years have been more in the nature of a free for all, in which there are no longer any clear rules of the game. Private business now finds itself being extorted by a wide array of elements in the bureaucracy—no longer just at the national level, but also at provincial and district/municipality levels, following the implementation of decentralisation in 2001.

So far as the judiciary is concerned, the basic problem now is that for decades under the Soeharto regime it was simply not regarded as important by the governments of the day that Indonesia should have a competent and efficient judiciary and court system. As in the bureaucracy, judges' salaries were set at very low levels. There was virtually no scrutiny of their legal decisions, and promotion focused on seniority (and, in practice, on loyalty to the franchise) rather than performance, as elsewhere in the bureaucracy. Decisions in the relatively few cases that did come to court were most often bought rather than being based on their legal merits, but as long as the judiciary and the legal bureaucracy performed the functions expected of them as part of the overall franchise system—protecting the regime against any kind of legal

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<sup>10</sup> Salary levels at the higher levels within the bureaucracy were far below the earnings capacity of individuals with equivalent skills working in the private sector. But there was never any shortage of young people wanting to join the civil service—even to the extent that they were willing to pay bribes to ensure their recruitment—because they felt confident that they had a good chance of earning high incomes through semi-legitimate and illegitimate means.

challenge, and making the 'right' decisions when the regime in itself wanted to use the courts against individuals and other entities – the individuals concerned could expect to prosper by virtue of the flow of corrupt payments to them. Those who tried to do an honest job were likely to be rewarded with a posting to some far-flung location, away from the real action.

### **An alternative view on the ease of doing business: legal heritage and development**

The foregoing discussion has described in some detail the nature of the entire system of government that existed in Indonesia just prior to the crisis of 1997–98. I have argued that the difficulties now faced by the private sector, as revealed by the *Doing Business* reports, are a consequence of this 'Soeharto legacy'.

This is not the only plausible explanation, of course. The first of the *Doing Business* reports was heavily influenced by Andrei Shleifer, Florencio Lopez-de-Silanes and Rafael La Porta, among others (World Bank 2004: vii). This group, along with colleague Robert Vishny, had published a number of papers in the late 1990s concerned with the importance of law to the operations of the finance sector, and hence to economic performance generally (see, for example, La Porta *et al.* 1997, 1998). One of the key empirical findings of these studies provides an alternative explanation for the obstacles to private sector activities – namely, that countries with a French civil law heritage<sup>11</sup> appeared to perform worst on quite a wide range of indicators of financial and economic development (La Porta *et al.* 1998):

... countries whose legal rules originate in the common law tradition tend to protect investors considerably more than the countries whose laws originate in the civil-law, and especially the French-civil-law, tradition...

German-civil-law and Scandinavian countries have the best quality of law enforcement. Law enforcement is strong in common-law countries as well, whereas it is the weakest in the French-civil-law countries. (p. 1151)

Perhaps it is not surprising that this view came to occupy a prominent place in *Doing Business in 2004*, as can be seen in the following passages taken from that report (in which the primary thrust was to argue that, in general, regulation is inimical to development):

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<sup>11</sup> Dutch law is in the French civil law tradition, and Indonesia is a former Dutch colony.

The regulatory regimes of most developing countries are not indigenous— they are shaped by their colonial heritage. When the English, French, Spaniards, Dutch, Germans, and Portuguese colonized much of the world, they brought with them their laws and institutions. After independence, many countries revised legislation, but in only a few cases have they strayed far from the original. These channels of transplantation bring about systematic variations in regulation that are not a consequence of either domestic political choice or the pressures toward regulatory efficiency. Common law countries regulate the least. Countries in the French civil law tradition the most. (p. xiv)

Which countries regulate business entry the most? ... Strong patterns emerge by legal origin. ... Countries in the French civil law tradition take the longest time and have the most procedures and highest cost. (p. 21)

In many countries, particularly those with a civil-law tradition, courts are tied up with cases such as the creation or voluntary dissolution of a company, where there is no dispute. Since such cases are usually numerous, they demand considerable court resources. (pp. 49–50)

Legal tradition is also associated with the efficiency of contract enforcement. Nordic countries have the fewest procedures ... the shortest time ... and the second-lowest (after Germanic countries) cost ... . Countries in the French legal tradition have the most procedures ... and the second-longest time and cost ... . (p. 48)

Legal tradition is the key determinant of creditor protections. Creditor-rights scores average 2.4 (out of a maximum of 4) in common-law countries, but only 1.5 for countries with French legal heritage ... . Lenders also face more delays and higher costs of enforcing collateral in French-origin countries. (p. 64)

The projection of the 'Law and Finance' academic literature into the more widely accessible (and potentially more practically influential) World Bank reports predictably caught the attention of the French legal community. I am reminded of a similar episode that occurred several decades ago in the field of psychology, when that profession began to undertake empirical studies of human intelligence, as measured by the 'intelligence quotient' (IQ). Early findings that IQ differed systematically among different racial groups, in particular, caused a great deal of angst among those concerned about racism, and thus generated a flood of further

research in this field. Much of the literature generated by this early finding cast doubt on the nature of IQ tests – suggesting, in particular, that they were biased by construction (albeit unintentionally) against particular racial groups.

I suspect that the law and finance literature is vulnerable to analogous kinds of criticism. As we have seen already, in the attempt to create quantitative indicators of the quality of regulation, the researchers have had to rely on their own subjective judgments as to the desirability or otherwise of particular kinds of laws and regulations, many of which are by no means unambiguously ‘good’ or ‘bad’. They have also had to make essentially arbitrary judgments about the relative importance of each such law or regulation, even in cases where there might be a broad consensus that they were counterproductive.

### **Plausibility of the Law and Finance view**

It seems difficult to take the Law and Finance literature too seriously. A key problem with it at the outset is that in fact it is rather difficult to categorise countries as to their legal systems. Even in continental Europe it is not sufficient just to distinguish civil from common law: the German tradition is regarded as significantly different from the French, and the Nordic tradition different from both of them. Likewise, there are quite significant differences between the UK and US common law systems. Moreover, to some extent there appears to be a process of convergence going on, as countries learn from their own and each others’ experience as to what works and what doesn’t in relation to law. So far as the developing countries are concerned, there is little doubt that they have been strongly influenced by their colonial heritage, but the colonial era was already drawing to a close six decades ago, and much has changed since then. Inherited colonial legal systems have had to accommodate traditional law and customs to some extent, and often they have been greatly affected by swings in political ideology of their governments – not least as a negative reaction to long periods of colonial domination and perceived exploitation.

Rather than continuing to discuss the issue in the abstract, however, let us focus on the economic performance of the main modern economies from the two principal legal systems identified in *Doing Business in 2004*: France, Germany and Sweden (all broadly from the civil law tradition), and the UK and the US (from the common law tradition). We wish to compare growth in real GDP (i.e. output adjusted for inflation) across this group of countries over fairly long periods of time (Table 3).

For the period 1971–2003, common law country the US far outperforms all others, with almost 170% growth in real GDP. Civil law France is well behind, although

slightly better than common law UK, while Germany and Sweden are still further back. But when we split this long period into two halves, the rankings change noticeably: France grows much more than the UK in the early years, but the positions are reversed in the second sub-period. Germany vies with Sweden for the position of poorest performer throughout, while the US greatly outperforms all the European countries in the sample in both sub-periods.

Table 3 Growth of Real GDP in Major Common Law and Civil Law Economies

(1971 = 100)

<b>1971-2003</b>			
	<b>%</b>		<b>%</b>
US	168.6		
France	110.7		
UK	107.7		
Germany	94.9		
Sweden	90.3		
<b>1971-87</b>	<b>%</b>	<b>1987-2003</b>	<b>%</b>
US	66.9	US	61.0
France	50.9	UK	45.3
UK	42.9	France	39.6
Sweden	40.3	Germany	39.1
Germany	40.1	Sweden	35.7

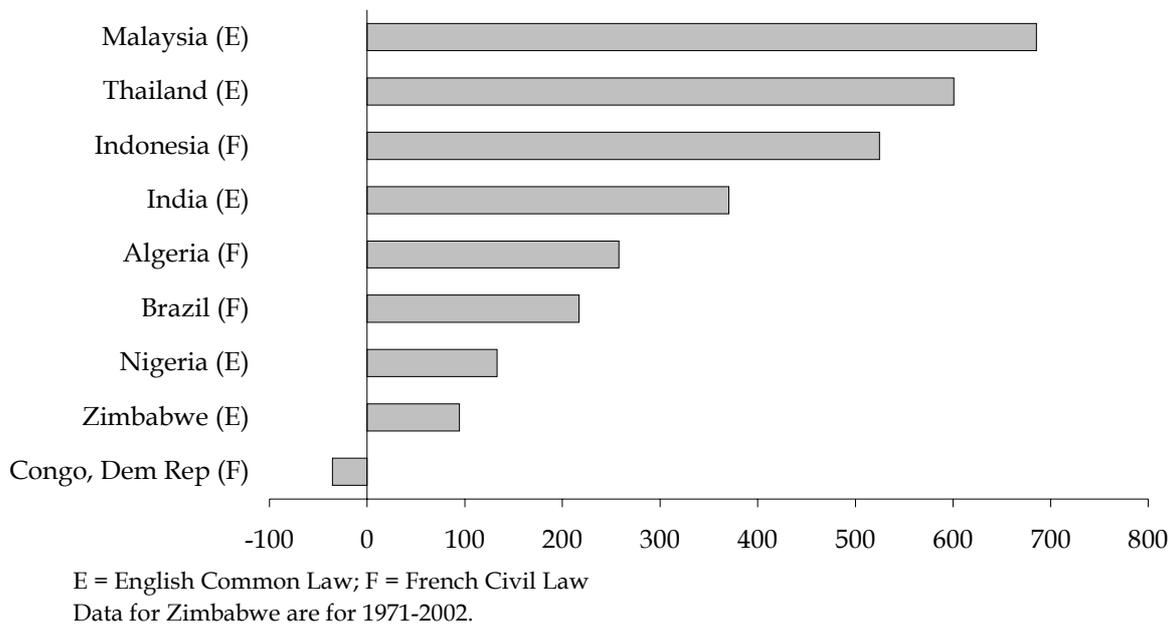
It is apparent that there is no obvious correlation between long-term growth performance and the type of legal system among countries that best represent the main legal families distinguished in the law and finance literature (common law, on the one hand, and French, Germanic and Nordic civil law on the other).<sup>12</sup> While common law US outperforms all the civil law countries, it also considerably outperforms common law UK. And although the UK grew much more rapidly than all the civil law countries from 1987-2003, its performance was little better than Germany and Sweden during the first half of this period, and well below that of France. An important point to note here is that, while each country's performance can vary substantially relative to the others over time, its legal heritage remains constant (by definition). In other words, a common law heritage does not guarantee permanently good performance, nor does a civil law tradition imply the reverse.

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<sup>12</sup> The fifth legal family, Socialist, is ignored here for brevity.

Turning now to a very different group of countries, this time with much less advanced economies, we find much the same story. Comparing real output growth of Algeria, Brazil, Congo (Democratic Republic), India, Indonesia, Malaysia, Nigeria, Thailand and Zimbabwe over almost a third of a century we again find enormous differences in performance, but no obvious correlation with legal heritage (Figure 10). All the countries in this sample are categorised as having either an English common law or French civil law heritage. Malaysia and Thailand, both common law countries, outperform the rest. Civil law Indonesia, a former Dutch colony, is not so far behind, and is well in front of India, with its British colonial heritage. At the other end of the scale, the former French colony Democratic Republic of The Congo claims the rare distinction of having gone backwards over this long period, but the former British colonies Nigeria and Zimbabwe have not done much better. Algeria and Brazil, both in the French legal tradition, are somewhere in between, but far behind the top performers.

**Figure 10 Real GDP Growth in Select Developing Countries 1971-2003 (%)**



To the extent any kind of pattern emerges here, it would appear to have much less to do with legal tradition than with geographic location. Southeast Asia is well known as the highest performing region of the world economy, while sub-Saharan Africa is clearly at the other end of the scale. Both South Asia and Latin America are somewhere in between. The small sample presented in Figure 10 is consistent with this general picture. This suggests that developing countries are perhaps more strongly influenced by the nature of their societies and by what their near

neighbours are doing than by their now distant colonial heritage.

Perhaps more to the point—returning to the earlier observation regarding empirical work on IQ testing—it has always seemed far more important to me that the frequency distributions of IQ across racial (or ethnic, or geographic) groups exhibit a great degree of overlap, so that differences in average values for such groups simply don't seem to matter: lots of Europeans are more intelligent than lots of East Asians, notwithstanding the fact that the average East Asian has a higher IQ than the average European. Even if the supposed causal link between legal heritage and development performance exists, this observation does not seem particularly helpful. There are certainly differences *between* the broad families of legal systems, but we can also observe vast differences *within* them, as *Doing Business in 2004* points out. For example:

A simple commercial contract is enforced in 7 days in Tunisia ... but takes almost 1,500 days in Guatemala [both of which are classified as French civil law countries in the report]. (p. xiii)

Rough attempts, like this, to quantify the quality of business regulation and legislation—and to employ such measures in inter-country comparisons, as in the *Doing Business* reports—are certainly a good way to motivate reform. But it seems more helpful simply to focus on the task of identifying, and then getting rid of, counterproductive regulation and legislation, and to emphasise improvement of the operations of the bureaucracy, judiciary, and other law enforcement agencies—regardless of the legal heritage of the country in question.

The World Bank seems to agree. The *Doing Business* reports of 2005 and 2006 have backed away entirely from this initial focus on the alleged malign influence of the French civil law tradition on business regulation and economic performance. There are no references to it whatsoever in either of these reports and, whereas the 2004 publication classified all countries according to their 'legal origin', the later reports do not do so. Indeed, this information is no longer even available in the online database (<http://www.doingbusiness.org/Default.aspx>). The emphasis now is on looking for general public sector hindrances to private sector performance—to 'doing business'—as indicated by quantitative measures of the impact of laws and regulations, regardless of their historical provenance.

### **The crisis as collapse of the franchise**

Aside from the alleged impact, in the Law and Finance literature, of legal heritage on countries' economic performance in normal times, it has been suggested also that

'[t]he impact of legal institutions on corporate finance may also play a role in explaining the Asian financial crisis' (Beck and Levine 2003: 27). Johnson *et al.* (2000) argue 'that weak legal institutions ... that do not effectively support the claims of outside investors ... help account for cross-country differences in stock market declines and exchange rate depreciations during the ... crisis' (Beck and Levine 2003: 27). The preceding analysis of the nature of the Soeharto regime—which came to an abrupt end as a result of this crisis—provides a basis for evaluation of the plausibility of this claim.

It needs to be emphasised that Soeharto's franchise system functioned very effectively for a very long time. It delivered rapid economic growth and poverty reduction over a period of some three decades, notwithstanding the fact that its objective was to expropriate wealth from the general public for the benefit of members of the franchise. The legal system that was built up over that time became utterly subservient to the wishes of the president, but was designed so as to be compatible with this outstanding economic performance. Nevertheless, the strength and coherence of the franchise was beginning to deteriorate by the first half of the 1990s.

As with all coalitions, the franchise could only work well as long as people believed that it would prevail over any opposition. But by the mid-1990s, the six Soeharto children (and some of their own children) were becoming more and more greedy for the spoils of office, inducing Soeharto to go along with increasingly poor microeconomic policy choices (such as the creation of a clove trading monopoly and a 'national car' program for the benefit of his youngest son) (Eng 1993: 30, Manning and Jayasuriya 1996: 18). Meanwhile, large businesses outside the ranks of the president's ethnic Chinese cronies and the first family had been proliferating and growing, and were also keen to grab a bigger share of the riches generated by the franchise. The strategic choice Soeharto had to make was whether to use up the resources of the franchise in fighting off these competitors, or to buy them off by bringing them into the franchise system. To a considerable extent, he chose the latter option, thus diluting its revenues among a larger membership.

Various other elements of society had begun to challenge the regime, not so much for a share of the financial gains, but rather, in relation to non-economic aspects, such as the desire for much greater political freedom: freedom of political parties to contend for office; freedom to speak out against corruption and the excesses of the state; freedom to push religious agendas; freedom to form trade unions; freedom to agitate on environmental issues; freedom to speak up for the traditional owners of land; and so on.

Again, Soeharto was obliged to make judgments about how to deal with each of these challenges. To some extent he tried to co-optation, such as by creating privileged positions for two non-government political parties (in which it was not expected that they could win office, but they could at least continue to exist and to be supported by the system, while lending Indonesia's 'democracy' an air of legitimacy). And to some extent he tried repression—for example, closing down newspapers and magazines, such as the respected *Tempo* (Pangestu and Azis 1994: 4). But sometimes these attempts tended to backfire. For example, Soeharto set up the National Commission on Human Rights and stacked it with his chosen appointees, only to find that it had an independent streak that it later used against him. Likewise, one of the tolerated political parties became very activist, recruiting Megawati Soekarnoputri, a daughter of former president Sukarno, as its figurehead. This move was so successful in providing a focus for anti-Soeharto discontent that the president felt obliged to engineer her replacement by a different individual, but this only resulted in the formation of a new splinter party—with Megawati as chairman, and with almost the exact same name—which attracted considerable and growing support.<sup>13</sup>

Another area in which the regime began to meet with resistance was in the unhappy province of East Timor, a former Portuguese colony that had been forcibly incorporated into Indonesia in 1975. In 1991 the military massacred a number of independence activists at the Santa Cruz cemetery in Dili, but the event was recorded on videotape and smuggled out for the rest of the world to see. This had a very strong impact in weakening international support for the regime—so much so that Soeharto felt it necessary to attack the Dutch for their outspokenness. Until that point the Dutch had chaired the 'Intergovernmental Group on Indonesia', a consortium of aid donors set up after Soeharto took over from Sukarno in the mid-1960s. Soeharto disbanded this group and had it replaced by a 'Consultative Group on Indonesia'—basically the same group of donors, but now excluding the Dutch, and chaired by the World Bank (Tomich 1992: 3). A few years later, in 1995, the rest of the world began to hear unsettling reports about large-scale environmental damage and human rights abuses in the province of Papua—location of the fabulously rich Freeport gold and copper mines. This also weakened international support for the regime, as did reports from elsewhere about the destruction of Indonesia's natural forests by uncontrolled logging.

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<sup>13</sup> Megawati was later to become president herself, in 2001.

An additional contributing factor here was the military – another key part of the franchise. Whereas Soeharto could have been thought of as the instrument of the military when he first came to power, over the years there was a subtle change in the relationship as Soeharto gradually came to dominate it. He shifted officers loyal to himself into higher and higher positions of power, allowing them to enrich themselves in the process, and thus buying their continuing support (Kristiadi 1999: 50). But here, too, the outcome was not entirely satisfactory from his point of view. The military never became a monolith. Different individuals within it were competing for the highest positions, albeit by doing whatever it took to curry favour with the president. To some extent he was careful always to play one off against the other, but the fact of the matter is that army generals are very powerful individuals, even if they are rivals. Toward the end of the regime, the rivalry between two such generals, Prabowo Subianto and Wiranto, became so intense that Soeharto began to lose control of this key branch of the franchise, and there is some suggestion that the horrific wave of arson, rape and murder directed at the ethnic Chinese community in major urban centres such as Jakarta and Surabaya in May 1998, when the president was out of the country, was directly related to this rivalry (O'Rourke 2002: 108–14).

Perhaps of greatest importance to continuation of the franchise, however, was the support of large-scale business – 'the conglomerates'. As we have seen, much of the income of the franchise flowed to it through the conglomerates. Microeconomic policymaking in the bureaucracy was, to a large extent, designed to generate rents (excess profits) for them, and in return, they found ways of channelling significant parts of these rents back to the franchise. The owners of the conglomerates had become fabulously wealthy during the Soeharto decades, but in the second half of 1997 serious doubts emerged, quite suddenly, about the president's chances of staying in office.

Inept handling of the emerging financial crisis by the central bank and the ministry of finance (McLeod 1998) would have given pause for thought about whether Soeharto could continue to deliver the macroeconomic stability that is essential for the continuing prosperity of any economy. The president by this stage was well advanced in years and, although he had outlived many of his contemporaries, there were increasing concerns about what would happen when, inevitably, he died or became incapacitated. There were signs that he was trying to groom one of his children (most likely his first daughter, 'Tutut') to take over, or perhaps a high-ranking military officer indebted to him for his appointment, but it was obvious that there would be great opposition to either of these outcomes on the part of the general public. Although there was a feeling (at least among the intelligentsia and

the growing middle class) that Soeharto had been in office much too long, there was also a sense that people were prepared to let nature run its course, and to elect a new president of their own choosing when that occurred. But the thought of some kind of dynastic succession seemed to be too much to stomach.

The emerging financial crisis marked a watershed in Indonesia's modern economic history. Apart from the few years during which Soeharto was consolidating his position and returning the economy from the chaos of the last few years under the founding president, Sukarno, never before had he had to bow to the wishes of the international community. But now, with the frighteningly rapid and totally unexpected loss of control of the macroeconomy by his policymakers, Indonesians witnessed the astonishing spectacle of the government having to turn to the international community for assistance.<sup>14</sup> Moreover, they saw that the international community was now making demands of the Soeharto government in relation to the kinds of economic policies it was following—and not merely in relation to direct concerns about the crisis. In particular, it was trying to persuade the government that it needed to disband the various special deals designed to enrich the first family and its cronies. Small wonder, then, that big business quickly saw the need to protect itself by shifting assets overseas.<sup>15</sup>

There are many stories about what caused the crisis in Indonesia, but for this writer it was all about the incipient demise of Soeharto's franchise system, given that the president had not been able to come up with any plausible, generally acceptable plan for a future in which he was no longer there as the franchisor. Big business, both domestic and foreign, which had chosen to ally itself in the past with the president, quickly realised the need to change its strategy and, in particular, to greatly reduce its exposure to Indonesia. Ethnic Chinese-owned conglomerates had been the major private sector beneficiaries of the franchise system, and the inability of the president to protect the Chinese community from the military and its associated private sector gangs of thugs during the May 1998 upheaval (O'Rourke 2002: chapter 7) also sent a clear message of the advisability of shifting assets out of the country. Shares in locally listed companies were sold, causing a drastic decline in share prices; loans

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<sup>14</sup> Nothing epitomised this so clearly as the widely published January 1998 photograph of the then head of the IMF, Michelle Camdessus, standing, arms folded, looking down on a seated Soeharto as the latter signed an agreement to undertake a wide range of policy reforms—the price of continued financial support from the international community during the crisis.

<sup>15</sup> This was somewhat ironic, in view of the fact that the IMF believed that business would be reassured by the introduction of austere economic policies, such that capital flight would be reversed.

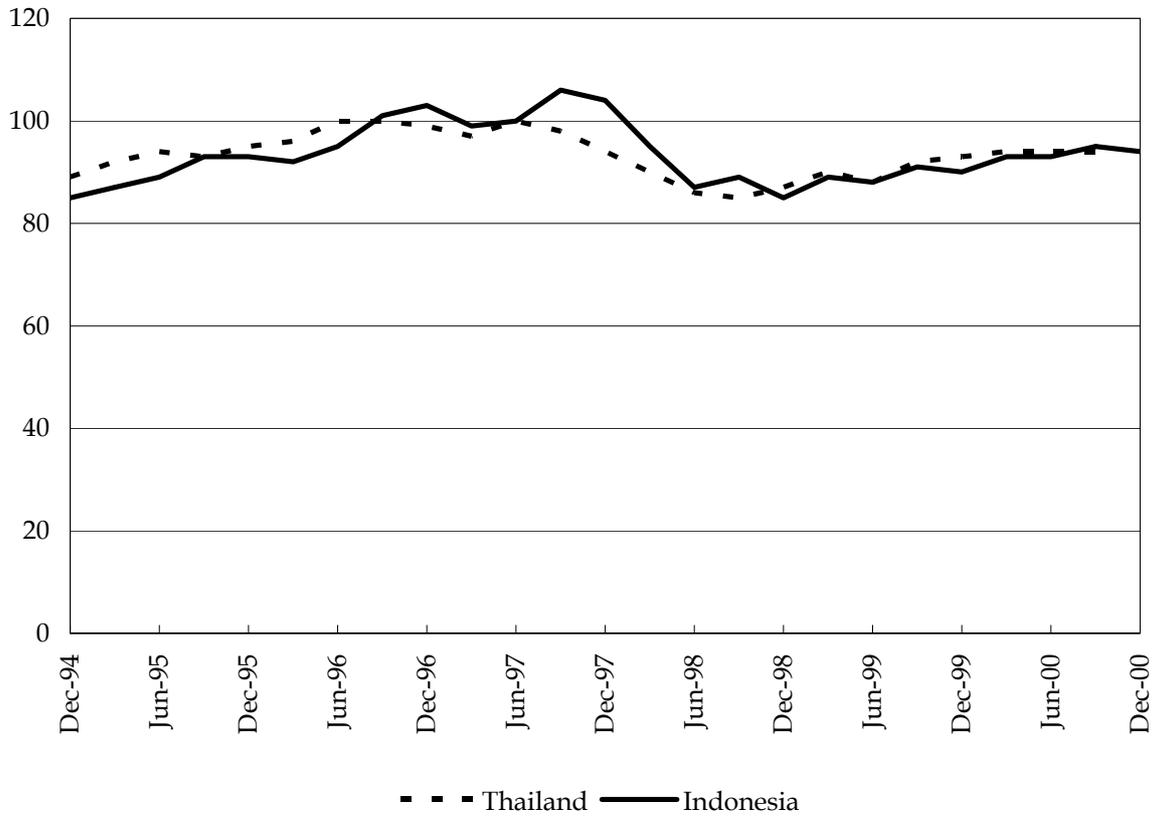
from overseas were liquidated and assets overseas purchased, pushing down the value of the rupiah and running down the level of the central bank's foreign exchange reserves. Panic on the part of the policymakers worsened the problem, causing a huge injection of liquidity to the banking system in a misguided attempt to keep it afloat – which, in turn, resulted in a sudden burst of high inflation, drastic depreciation of the currency, and a wealth transfer from the general public to the owners of the conglomerates on a grand scale.

### **Legal systems or central banks as crisis explainers?**

It is worth noting here that Thailand, classified as a common-law heritage country in the 2004 *Doing Business* report, suffered just as badly as Indonesia during the crisis of 1997–98, if we focus on the impact on economic growth (Figure 11). Korea and Malaysia, which are regarded as following German civil law and UK common law legal traditions, respectively, fared just as badly as each other during the crisis. Likewise, if we focus on Taiwan and Singapore, again regarded as following German civil law and UK common law traditions, respectively, we find that both countries were able to overcome the crisis very quickly, with minimal damage. Such observations cast strong doubt on any assertion that legal tradition had anything to do with the crisis.

On the contrary, the severity of crisis seems to have depended heavily on the macroeconomic policies of the respective central banks. Indonesia's central bank and its ministry of finance contributed greatly to the severity of the crisis in that country by lending heavily to failing banks and then guaranteeing their liabilities, and by failing to allow the value of the rupiah to be determined in the market—despite nominally having chosen to float the currency just a few months earlier. Likewise in Thailand, the central bank's policies clearly contributed greatly to the crisis. For many months before the baht was floated in July 1997 the central bank had been selling its foreign exchange on the forward market, which allowed it to pretend that its foreign reserves position was still strong. But the market was well aware of what was going on, and soon came to realise that it could not fail to make a handsome profit from currency speculation. Thus, rather than looking for an explanation in terms of legal system heritage, it seems more appropriate to ask why the central banks of these two countries so clearly failed to get their policies right.

**Figure 11 Real GDP Thailand and Indonesia**  
(June 1997 = 100)



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