The Paradox of Free-Market Democracy: Indonesia and the Problems Facing Neoliberal Reform

A Paper from the Project on Development, Trade, and International Finance

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FOREWORD

In the wake of the 1997–98 financial crises in emerging economies, many prominent thinkers focused their energies on what went wrong, how it could have been prevented, and what reform measures are required for the future. While some concentrated specifically on financial markets within the economies in question, others examined the larger system wide implications. The Council on Foreign Relations Project on Development, Trade, and International Finance convened a Working Group in an attempt to look at the problem from both levels, to investigate the problems in the world economy that led to the crises, and to propose policy options calculated to prevent future large-scale disturbances.

Specifically, the goal of the Working Group, which began in 1999, was to promote discussion of different perspectives about the necessity for change in the world economic system, and to look at concrete forms that change might take. These included, but were not limited to, discussions about reforming the international financial architecture to facilitate a transition from export-led growth to internally or regionally demand-driven development strategies that offer the populations of the developing world an improved standard of living.

One of the Working Group's several undertakings was to commission papers from the participants on a broad range of subjects related to the international financial architecture. The authors come from a variety of backgrounds, and their papers reflect a diversity of perspectives. However, we believe that all of them provide insights into international financial architecture, and that they represent collectively factors that should be considered by both U.S. and international economic policy makers.

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The Paradox of Free-Market Democracy: Indonesia and the Problems Facing Neoliberal Reform[1]

INTRODUCTION

This paper will situate the recent problems in Indonesia in a more general framework that I will call the paradox of free-market democracy. The basic thesis I will advance is as follows. In Indonesia, as in many developing countries, class and ethnicity overlap in a distinctive and potentially explosive way: namely, in the form of a starkly economically dominant ethnic minority—here, the Sino-Indonesians. In such circumstances, contrary to conventional wisdom, markets and democracy may not be mutually reinforcing. On the contrary, the combined pursuit of marketization and democratization in Indonesia may catalyze ethnic tensions in highly determinate and predictable ways, with potentially very serious consequences, including the subversion of markets and democracy themselves. The principal challenge for neoliberal reform in Indonesia will be to find institutions capable of grappling with the problems of rapid democratization in the face of pervasive poverty, ethnic division, and an historically resented, market-dominant "outsider" minority.[2]

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[1]This paper is based on a number of earlier articles by the author.

[2]The recent crises in East Timor, Aceh, and the Moluccas are not the subject of this paper. Needless to say, Indonesia will also have to find ways of addressing separatist demands and ethnic conflict in its various regions as it pursues democratization and market reforms.

BACKGROUND

The Paradox of Free Market Democracy

I will begin by briefly explaining what I mean by the paradox of free-market democracy. It has to be remembered that there is a fundamental tension between the two major thrusts of international development policy: markets and democracy. Throughout the developing world, markets have characteristically produced wealth concentrated in the hands of a few. As long as this continues to be so, the introduction of democratic politics, which—at least theoretically—puts political power in the hands of the impoverished majority, will always be a source of tremendous potential instability. This is not a new point. Among many others, Adam Smith, David Ricardo, and James Madison all held that markets and democracy could coexist, if at all, only in fundamental tension with one another.[3] That is why these figures opposed universal suffrage, which according to Thomas Babington Macaulay, was "incompatible with private property" and thus "with civilization" itself.[4] From this point of view, free-market democracy is a paradox, a contradiction in terms.[5]

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[3]James Madison, *Notes of Debates in the Federal Convention of 1787* (Ohio University Press, 1984), pp. 403–4; *The Works and Correspondence of David Ricardo*, vol. 7, Piero Sraffa ed. (Cambridge University Press, 1952), pp. 369–70; Adam Smith, *An Inquiry Into the Nature and Causes of The Wealth of Nations*, bk. V, ch. I, pt. II (1776; Chicago: University of Chicago Press, 1976), p. 232.

[4]Thomas Babington Macaulay, *Complete Writings*, vol. 17 (Houghton, Mifflin and Co., 1900), pp. 268.

[5]Many have discussed the "antagonistic symbiosis between democracy and market-capitalism." See Robert Dahl, *On Democracy* (New Haven, CT.: Yale University Press, 1998), p. 161; James M. Buchanan, *The Limits of Liberty: Between Anarchy and Leviathan* (Chicago, University of Chicago Press, 1975), pp. 147–65; Jürgen Habermas, *The New Conservatism,* Shierry Weber Nicholsen, ed. & trans., (Cambridge: MIT Press 1994), pp. 55–56; Charles E. Lindblom, *Politics and Markets* (New York: Basic Books, 1966), pp. 159, 161; Adam Przeworski, "The Neoliberal Fallacy," *in Capitalism, Socialism, and Democracy Revisited*, ed. Larry Diamond and Marc F. Plattner (Baltimore: Journal of Democracy Publications, Johns Hopkins University Press, 1993).

As it turned out, of course, the paradox of free-market democracy did not prove insuperable. Far from it, in all the developed nations, this paradox has been successfully mediated by a host of institutions, substantially defusing the conflict between market-generated wealth disparities and majoritarian politics. One of most important challenges facing developing-world policymakers today is to identify these institutions and to think much more carefully and creatively about how analogous institutions might be promoted in the developing world. This is the subject of a much longer article I have recently published.[6]

The Problem of Market-Dominant Minorities and Ethnonationalism

For purposes of analyzing Indonesia, I will focus on a specific problem concerning the paradox of free-market democracy: the phenomenon of economically dominant ethnic minorities. In contrast to the Western nations and all of the East Asian Tigers, many developing countries have one or more ethnic minorities, who, for widely varying reasons, historically have dominated economically the "indigenous" majorities around them. The most prominent example is the Chinese throughout Southeast Asia. However, such minorities have also included: Indians in East Africa and parts of the Caribbean, Lebanese in West Africa and parts of the Caribbean, Ibo in Nigeria, Kikuyu in Kenya, Bamileke in Cameroon, Tutsi in Rwanda, Russians (along with Germans, Ukrainians, and Koreans) in Central Asia, Whites in South Africa and Zimbabwe, Tamils in Sri Lanka, Bengalis in Assam—the list goes on, quite strikingly, as I have documented in detail elsewhere.[7] Moreover, in part because of historical or "path dependent" reasons, many economically dominant minorities will also tend to be *market-dominant*. In other words, their economic dominance will not dissipate but rather persist or even increase with privatization and other

[6]See Amy L. Chua, "The Paradox of Free Market Democracy: Rethinking Development Policy," *Harvard International Law Journal*, vol. 41, no. 2 (2000).

[7]See Amy L. Chua, "Markets, Democracy, and Ethnicity: Toward a New Paradigm for Law and Development," *Yale Law Journal*, vol. 108, no. 1 (1998), pp. 21–26.

market-oriented reforms, at least in the near to midterm future.[8] This certainly seems to be true of the "entrepreneurial" Chinese minorities in Southeast Asia, who dominate the private sector and often benefit disproportionately from foreign investment liberalization, privatization, and other market-oriented reforms.[9]

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[8]As I discuss below in the context of the Indonesian Chinese, conventional wisdom effectively assumes that market reforms will solve the problem of economically dominant minorities by eliminating monopolistic structures and by "leveling the playing field." This might sometimes be the case—for example, if a particular ethnic minority owes its economic dominance solely to political favoritism or military force. Unfortunately, the underlying causes of economic dominance are rarely so clear, and even if they are, they will rarely prove tractable. The awkward reality is that many economically dominant minorities will also tend to be market-dominant. There are a number of reasons for this. To begin with, "economic liberalization naturally favors private business while reducing the role and influence of bureaucrats and the state."; see Linda Y.C. Lim and L. A. Peter Gosling, "Strengths and Weaknesses of Minority Status for Southeast Asian Chinese at a Time of Economic Growth and Liberalization," in *Essential Outsiders: Chinese and Jews in the Modern Transformation of Southeast Asia and Central Europe,* Daniel Chirot and Anthony Reid, eds., (Seattle: University of Washington Press, 1997), pp. 285, 295. Thus in the many developing societies in which the private sector is overwhelmingly dominated by a particular ethnic minority, economic liberalization will likely disproportionately benefit that minority, at least in the earlier years (or decades) of marketization. This will be especially true where the economic regulations being swept away—and the state-owned enterprises being dismantled—were originally established to curtail the economic dominance of the ethnic minority in question. Along the same lines, economically dominant minorities frequently control (or at least are disproportionately represented in) those sectors of the economy that are most attractive to foreign investors: for example, finance, technology, industry, transport, and mining and other natural resources. Thus, they often are better positioned to benefit from foreign investment liberalization (for example, in the form of lucrative joint ventures). Some of this market dominance may reflect "superior entrepreneurialism," which itself can result from a number of factors, from culture to a history of political favoritism by colonial authorities. At the same time, more invidiously, some economically dominant minorities may be market-dominant because, like Whites in apartheid South Africa, they have oppressed the indigenous majorities around them for so long that it will be decades before education levels and entrepreneurial experience come close to being equalized. I discuss the causes of market dominance at length elsewhere. See Chua, "The Paradox of Free Market Democracy." pp. 316–21.

[9]Indeed, as one source has put it (perhaps a little too vividly), the "rapid region-wide economic growth" since the 1980s "has turned Southeast Asia into a 'South China Sea' of ethnic Chinese capital and labor movements, greatly increasing the visibility and the actual presence of both foreign and local Chinese in regional economies." See Lim and Gosling, "Strengths and Weaknesses of Minority Status for Southeast Asian Chinese at a Time of Economic Growth and Liberalization," p. 289. More recently, economic liberalization in Vietnam and Burma has led to a resurgence of Chinese commercial dominance in these countries' urban areas. See Chua, "Markets, Democracy, and Ethnicity," pp. 22–23.

The phenomenon of market-dominant minorities has a number of sobering implications for neoliberal reform. Most crucially, the existence of market-dominant minorities, combined with other conditions prevalent throughout the developing world, converts the paradox of free-market democracy into an engine of potentially catastrophic ethnonationalism. This is because in developing countries with a market-dominant minority, *markets and democracy will tend to favor not just different people, or different classes, but different ethnic groups*. Markets will (by definition) benefit the market-dominant minority, while democracy will increase the power of the relatively impoverished majority. In these circumstances, the combined pursuit of markets and democracy will tend to produce an ethnically charged and highly unstable situation. More specifically, as I have modeled elsewhere,[10] in countries satisfying certain specified conditions, including economic underdevelopment and the presence of a market-dominant minority, marketization and democratization will tend to produce highly determinate and potentially highly destructive ethnoeconomic and ethnopolitical consequences,[11] along the following lines.

First, by causing, maintaining, or exacerbating the disproportionate wealth of the market-dominant minority, marketization will cause, maintain, or exacerbate intense ethnic resentment among the impoverished, indigenous majority. Next, with democratization, this ethnoeconomic resentment will tend to be transformed into a potent ethnonationalist movement, in part because politicians will have powerful incentives to scapegoat the resented economically dominant minority and foment ethnic hatred to their advantage. The result of this process will often be the ethnicization of the paradox of free-market democracy. An aroused ethnonationalist majority will emerge. Perceiving markets as solely or principally benefiting a resented ethnic minority, that major-

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[10]See Chua, "Markets, Democracy, and Ethnicity," pp. 33–56.

[11]To be clear, the suggestion is not that democracy is necessary (or more likely than authoritarianism) to trigger an ethnonationalist reaction. Rather, the point of the model is to explore the distinctive dynamics and problems that are likely to arise when markets and democratization are simultaneously pursued in the face of a market-dominant minority. See Chua, "Markets, Democracy, and Ethnicity."

ity will demand policies that will end the minority's economic dominance, so that the nation's wealth and identity can be reclaimed by its "true owners." Under these circumstances, one of three non-mutually exclusive outcomes becomes highly probable: (1) an anti-market backlash targeting the market-dominant minority (for example, through ethnically targeted nationalizations or economic restrictions); (2) actions aimed at eliminating the market-dominant minority (for example, through expulsion or atrocity); and (3) a pro-market retreat from democracy. As I have documented in detail, each of these outcomes has occurred repeatedly throughout the developing world.[12] They are, however, perhaps most vividly illustrated by contemporary Indonesia.

[12]See Chua, "Markets, Democracy, and Ethnicity."

INDONESIA

The Chinese in Pre-Colonial and Colonial Indonesia

As in all the Southeast Asian countries, the ethnic Chinese in Indonesia have long represented an economically dominant minority vis-à-vis the indigenous majority around them: in this case, the *pribumi* ("of the earth").[13] Indeed, the economic dominance of the Chinese in Indonesia predates Dutch colonialism by several centuries. According to Clifford Geertz, in pre-colonial Indonesia,

> all foreign trade in the [Tabanan] kingdom—the main export was coffee, the main import opium—was conducted by a single wealthy Chinese called a subandar, who held a royal monopoly in exchange for a suitable tribute, the remainder of the small resident Chinese population acting as his agents. Domestic trade was trifling . . . [14]

The Chinese began arriving "in large numbers in the nineteenth and early twentieth centuries, when the Dutch colonial government offered them both economic opportunity and a measure of

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[13]This is by no means to suggest that indigenous Indonesians are homogeneous—nothing could be further from the truth. Indonesia's "nearly 200 million people are divided into hundreds of distinct cultural groups living for the most part in regional homelands, . . . from Aceh on the northern tip of Sumatra to Irian Jaya."; see R. William Liddle, "Coercion, Co-optation, and the Management of Ethnic Relations in Indonesia," in *Government Policies and Ethnic Relations in Asia and the Pacific*, ed. Michael E. Brown and Sumit Ganguly (Cambridge, Mass.: MIT Press, 1997), pp. 273, 274. "Typically, the members of each group speak their own language or dialect and have a strong sense of their distinctiveness" (ibid.). Among indigenous Indonesians, a principal "axis of conflict has been the relationship between the Javanese, who almost constitute a majority, and all the other groups, who have feared domination by the Javanese" (ibid., p. 279). Indonesians are divided along religious lines as well. Roughly 86 percent of the country is Muslim; most Balinese are Hindus, and "Protestant and Catholic adherents are heavily concentrated among specific regional ethnic groups" (ibid., p. 274).

[14]Clifford Geertz, *Peddlers and Princes: Social Change and Economic Modernization in Two Indonesian Towns* (Chicago: University of Chicago Press, 1963), pp. 25–26. Tabanan, a town in southwest Bali about twenty miles west of Den Pasar, is the former seat of a Balinese royal court (ibid., p. 7).

personal security."[15] During the colonial era, wealthy Chinese merchants, along with "Javanese aristocrats turned bureaucrats (*priyayi*)," served as "local elite intermediaries" for the Dutch.[16] The main role of the Chinese was to operate for the Dutch highly profitable "revenue farms and monopoly concessions for running local markets, collecting fees, selling salt and opium, running pawnshops, and so on. The most important of these from the 1850s to the 1880s were the opium farms."[17] At the same time, Chinese moneylenders dominated colonial Java's rural credit sector.[18] The result of this "plural" colonial economic structure was the concentration of economic power largely in Chinese and European hands and the distinctly "inferior economic position of the Indonesians."[19]

The Dutch revenue farms were dismantled in the 1890s, which caused the Chinese to seek "new investment opportunities in kretek (clove) cigarettes, batik, and other industries hitherto dominated by the native bourgeoisie."[20] Thus, around the turn of the century, the Chinese "came into direct conflict with a native class for the first time in their history on the Indies."[21] As many scholars have noted, the emergence of Indonesian nationalism at the turn of the century was inextricably bound up with "the sudden increased impingement of aggressively competitive Chinese entrepreneurs upon the interests of the vestigial Javanese merchant class."[22] The Sarekat Islam, Indonesia's "first popular native nationalist movement" (born in late 1911 in Central Java) was marked by "[v]iolent, popular anti-Sinicism."[23]

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[15]R. William Liddle, "Coercion, Co-optation, and the Management of Ethnic Relations in Indonesia," p. 278.

[16]Takashi Shiraishi, "Anti-Sinicism in Java's New Order," in Chirot and Reid, eds., *Essential Outsiders*, pp. 187, 195.

[17]Ibid.

[18]Ibid., p. 199.

[19]Frank H. Golay, Ralph Anspach, M. Ruth Pfanner, and Eliezer B. Ayal, *Underdevelopment and Economic Nationalism in Southeast Asia* (Ithaca, N.Y.: Cornell University Press, 1969), p. 115, see also pp. 113–18.

[20]Shiraishi, *Anti-Sinicism in Java's New Order*, pp. 187, 189.

[21]Ibid.

[22]George M. Kahin, *Nationalism and Revolution in Indonesia* (Ithaca, N.Y.: Cornell University Press, 1952), p. 67.

[23]Shiraishi, *Anti-Sinicism in Java's New Order*, p. 187.

Post-Independence Indonesia under Sukarno and Suharto

Following independence in 1949, the relatively laissez-faire economic policies of the colonial period gave way to a period of "professed socialist ideals." During the period of Guided Democracy (1959–65),[24] President Sukarno's nationalizations of land and private enterprise targeted not just the British and the Dutch but also, very explicitly, the ethnic Chinese–an instance of the first outcome noted above (ethnically-targeted anti-market backlash). Indeed, through nationalization and other measures of economic nationalism, Sukarno "indigenized" much of the Chinese-dominated financial sector; sixty percent of Indonesia's foreign trade; mining and most of the modern industrial sector; and the greater part of Indonesia's importing trade, including the lucrative, Chinese-controlled batik and rice sectors.[25] It is important to recognize that Sukarno's nationalization programs were far more an expression of ethnonationalism than of socialism. Unlike in the former Soviet Union or China, Sukarno, despite his occasionally Marxist rhetoric, never sought to eliminate the institution of private property or to level the class structure. On the contrary, Sukarno left the market system more or less intact outside of the nationalized industries.

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[24]"In July 1959, President Sukarno, in alliance with the central leadership of the armed forces, decreed a return to the revolutionary constitution of 1945, under which the president was the dominant actor in the political system. Suharto labeled his new regime Guided Democracy (the Indonesian term is *Demokrasi Terpimpin*, which translates more accurately as Democracy with Leadership). Although Sukarno did not have unlimited power, the system was in essence a presidential dictatorship."; see Liddle, "Coercion, Co-optation, and the Management of Ethnic Relations in Indonesia," p. 287. Thus, Clifford Geertz has suggested that the differences between Sukarno's "old order" populism and Suharto's "new order" paternalism "have been much exaggerated by the partisans of both—their contrasts were mainly in style and presentation, and to some degree in disciplinary reach."; see Clifford Geertz, "Indonesia: Starting Over," *New York Review of Books* (May 11, 2000), pp. 22, 24.

[25]See Amy L. Chua, "The Privatization-Nationalization Cycle: The Link Between Markets and Ethnicity in Developing Countries," *Columbia Law Review*, vol. 95 (1995), pp. 254, 269 (citations omitted). Despite his "indigenization" campaign, Sukarno was criticized by ethnic Indonesians for "his protective attitude to the Chinese minority," perhaps reflecting the gradual rapprochement under Sukarno between Indonesia and China. See ibid., note 370, p. 269 (citation omitted).

By contrast, the thirty-year "capitalist-style" autocracy of General Suharto is a paradigmatic example of the third outcome noted above (pro-market retreat from democracy). After seizing power militarily in 1965, Suharto proceeded to quash rival political parties and to extinguish opposition of all kinds.[26] In return for the support of the World Bank and the International Monetary Fund, Suharto adopted aggressive privatization and economic liberalization policies to encourage foreign investment and rapid economic growth.[27] To that end, Suharto reached out to the Chinese business community. Throughout his rule, Suharto not only protected the Chinese politically,[28] but affirmatively directed lucrative business opportunities to them.[29] These favors were returned by the Indonesian Chinese. With their "business expertise, international connections, and preexisting business links with the armed forces,"[30] they not only fueled the country's economy—Indonesia enjoyed tremendous growth during the New Order, with the economy expanding six-fold[31]—but also added enormously to the personal wealth of the Suharto family.[32]

By the end of the Suharto regime, Sino-Indonesians occupied a position of economic dominance wildly disproportionate to

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[26]See Chua, "The Privatization-Nationalization Cycle," p. 55 (citations omitted).

[27]See ibid.; also Michael R. J. Vatikiotis, *Indonesian Politics Under Suharto* (New York and London: Routledge, 1993), pp. 39–41; Liddle, "Coercion, Co-optation, and the Management of Ethnic Relations in Indonesia," pp. 300–1.

[28]In 1971 an article appeared in the *Bangkok Post* reporting that Indonesia's *Cukongs*, consisting of about twenty ethnic Chinese, had "wide holdings ranging from airlines and banks to flour mills, import-export companies, tourist corporations, restaurants, shipping companies, tin exporting concessions, rice milling plants, [and] timber concessions."; see Leo Surydinata, "Indonesian Policies Toward the Chinese Minority Under the New Order, "Asian Survey," vol. 16 (1976), pp. 770, 772–73. The article also stated that the *Cukongs* had a steady inside track to government contracts and investment credits and that 90 percent of project aid money ended up in the hands of *Cukongs*. The article was translated and published in *Nusantra*, a leading Jakarta daily, leading to inquiries by members of Parliament. The government denied the charges, and the editor of *Nusantra* was prosecuted and sentenced to two years in prison. See ibid.

[29]See Chua, "The Privatization-Nationalization Cycle," p. 55 (citations omitted).

[30]William Ascher, "From Oil to Timber: The Political Economy of Off-Budget Development Financing in Indonesia," *Indonesia Journal* (Cornell University), vol. 65, Spring 1998, pp. 37, 53.

[31]Geertz, "Indonesia: Starting Over," p. 22.

[32]See Chua, "The Privatization-Nationalization Cycle," p. 55 (citations omitted).

their numbers. Comprising only some 3 percent of the population,[33] the ethnic Chinese in Indonesia controlled up to 70 percent of the private economy under a number of different measures.[34] All of Indonesia's billionaires reportedly have been ethnically Chinese,[35] and, until very recently, almost all of the country's largest conglomerates were owned by Sino-Indonesian families.[36] The major exception to this rule were companies owned by the children of President Suharto, which themselves "depended for their success on state favors and links with Sino-Indonesians."[37] On a smaller scale, ethnic Chinese dominated petty trading occupations in rural areas and retail and wholesale trade in urban areas,[38] as well as the country's informal credit sector.[39] Indeed, "[p]ractically every tiny town [had] an ethnic Chinese–run general store that [was] the center of local economic life."[40]

Not surprisingly, this state of affairs provoked massive, widespread hostility among the *pribumi* majority. Suharto's

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[33]"No reliable figures on the number of Chinese in Indonesia have been collected since the 1930 census; all later estimates . . . appear to be based on calculations that they still represent either 3 or 4 percent of the total population, although even that can be only an informed guess." See Jamie Mackie, "Economic Systems of the Southeast Asian Chinese," in Leo Surydinata, ed., *Southeast Asian Chinese and China: The Politico-Economic Dimension* (Singapore: Times Academic Press, 1995), p. 62.

[34]See, e.g., Surydinata, *Southeast Asian Chinese and China*, p. 770; "A Taxing Dilemma," *Asiaweek* (October. 20, 1993), p. 53 (reporting that, according to the Sakura Bank-Nomura Research Institute, in 1991 Indonesian Chinese comprised 3.5 percent of the population but commanded a 73 percent share of the country's listed equity); see also Lim and Gosling, "Strengths and Weaknesses of Minority Status for Southeast Asian Chinese at a Time of Economic Growth and Liberalization," p. 312 (offering similar estimates).

[35]See Joel Kotkin, *Tribes: How Race, Religion, and Identity Determine Success in the New Global Economy* (New York: Random House, 1993), p. 180.

[36]Liddle, "Coercion, Co-optation, and the Management of Ethnic Relations in Indonesia," p. 301.

[37]Ibid.

[38]Vatikiotis, *Indonesian Politics Under Suharto*, p. 101; David Lamb, "Terrorized Ethnic Chinese Still on Edge in Indonesia Southeast Asia," *Los Angeles Times*, October 3, 1998, p. A4.

[39]Following a tradition reportedly dating to the seventeenth century, ethnic Chinese ran "thousands of small factories that make everything from shoes to auto parts." These Chinese-owned "general stores" "double[d] as credit agencies to farmers and laborers." See Michael Shari and Jonathan Moore, "The Plight of the Ethnic Chinese," *Business Week* (August 3, 1998), p. 48.

[40]Ibid.

resignation in May 1998 was accompanied by an eruption of vicious anti-Chinese violence, in which nearly five thousand shops and homes of ethnic Chinese were burned and looted,[41] more than two thousand people died,[42] and many ethnic Chinese women were raped.[43] Within a month, approximately 110,000 Sino-Indonesian families (including some of the wealthiest) left the country,[44] along with massive amounts of Chinese-controlled capital, estimated at $40-$100 billion.[45] The preceding events made Indonesia during this period an illustration of the second (eliminationist) outcome noted above.

Markets, Democracy, and Ethnic Conflict in Post-Suharto Indonesia

The brief, troubled government of Dr. B. J. Habibie, who took over from Suharto in May 1998, was characterized by blatant economic nationalism. As Suharto's research and technology minister, Habibie had for years advocated state-ownership of Indonesia's Chinese-dominated industrial and technological sectors.[46] After Suharto's resignation, it became clear that there was a widespread belief among the *pribumi* that New Order economic liberalization favored the " 'already strong' " Sino-Indonesians at the expense of

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[41]See Gregg Jones, "Fear Overwhelming Indonesia's Chinese," *Dallas Morning News*, October 4, 1998, p. 1A.

[42]See ibid. Most of those who died were "non-Chinese looters trapped in burning shopping malls."

[43]See ibid. According to local human rights workers, " 'more than 168 women'—most of them ethnic Chinese—were gang-raped during the riots." The Habibie government denied these allegations, claiming that they were "exaggerated."

[44]See Jay Solomon, "Indonesia's Chinese Move to Increase Civil Rights After a Decades-Long Ban on Political Activities," *Wall Street Journal*, June 9, 1998, p. A14. While most of these families have returned to Indonesia, most have also been reluctant to reinvest in Indonesia. See Barry Porter, "Wahid Starts Drawing Home Lost Billions," *South China Morning Post*, November 2, 1999, p. 10.

[45]See Ravi Velloor, "Fix Chinese Issue, Indonesia Told," *Straits Times*, October 10, 1998, p 2; Kafil Yamin, "Economy–Indonesia: Not Too Happy With Very Strong Currency," Inter Press Service, July 2, 1999.

[46]Liddle, "Coercion, Co-optation, and the Management of Ethnic Relations in Indonesia," p. 316; Raphael Pura, "Technology Guru Stands Out in Indonesia," *Wall Street Journal*, November 21, 1994, p. B6D.

the " 'economically weak' " indigenous Indonesians. "According to this logic, the obvious cure is a new set of regulations, a reimposition of government intervention."[47] Playing on these popular sentiments, the Habibie government (greatly influenced by Habibie's nationalistic and very popular minister for cooperatives, Adi Sasano), advanced a proposal for a "People's Economy" (*Ekonomi Rakyat*), which was based on "economic justice." The plan envisioned "the breaking up of Chinese-dominated enterprises and transferring them to the long-suffering masses, using cooperatives and small- to medium-scale industries as receivers."[48]

International pressure, together with a desire to prevent continuing flight of Chinese capital, led the Habibie administration to temper its rhetoric somewhat, assuring the Chinese at one point, for example, that "we will not nationalize assets held by the private sector and foreign companies."[49] Nevertheless, although not well known in the international community, the Habibie government expressly pursued policies of ethnically targeted market intervention (again, the first outcome discussed previously); not surprisingly, with drastically negative economic effects. The country's recent rice shortage provides a dramatic illustration.

Until May 1998, Indonesia's rice-distribution network was dominated by ethnic Chinese traders, who operated a fairly efficient system, "despite some profiteering on their part and despite the payoffs they had to make to an increasingly venal indigenous bureaucracy."[50] After Suharto's resignation, the Habibie government—in an openly ethnonationalist move supported by majoritarian sentiment—canceled rice distribution contracts with hundreds of ethnic Chinese businesses and awarded them instead to indigenous Indonesians, some of whom had little or no

[47]Liddle, "Coercion, Co-optation, and the Management of Ethnic Relations in Indonesia," pp. 300–1, 316.

[48]Abdul Razak Ahmad, "People's Economy to the Rescue?" *New Straits Times* (Malaysia), December 21, 1998, p. 6.

[49]Tom McCawley Serang, "A People's Economy," *Asiaweek*, December 18, 1998, p. 62.

[50]David Jenkins, "The Business of Hatred," *Sydney Morning Herald*, October 28, 1998, p. 8.

experience in the field. The results were disastrous, part of a food crisis in which tens of millions of Indonesians were at one time reportedly eating only one meal a day.[51] The new state-run rice cooperatives were immediately saturated with corruption, inefficiency, and scandal. (For example, one official was accused of trying to export illegally 1,900 tons of rice to Malaysia, while his own constituents were starving). Predictably, indigenous officials and businessmen began secretly to subcontract work out to Chinese traders again.[52]

Indonesia's national election in 1999—protracted and vastly complicated but evidently fair and open[53]—raised great hopes in the international community. Habibie's (and formerly Suharto's) Golkar party lost definitively, and the proposals for a People's Economy were taken off the policy agenda (at least for the moment). The country's new president, Abdurrahman Wahid, is widely admired for his liberalism, tolerance, and commitment to human rights. From the outset, President Wahid has supported both "democratic reforms" and IMF-dictated pro-free-market policies.[54] In other words, the combined pursuit of markets and democracy is once again the prevailing prescription.

But the point of this paper has been precisely to suggest that the conflict in Indonesia between these two goals is likely to be intense and combustible. With poverty pervasive, and "its banks and largest corporations still mired in delinquent debts," Indonesia remains "in its worst economic crisis in a generation."[55] The goal of pro-market reforms is explicitly to procure the return of foreign investment and Chinese-controlled capital, without which experts agree the Indonesian economy cannot be restarted.[56] (It is no

[51]See "Indonesia's Anguish," *New York Times*, October 16, 1998, p. A26.

[52]See "The Business of Hatred."

[53]Geertz, "Indonesia: Starting Over," p. 24.

[54]See David Lamb, "Coalition Government Likely in Indonesia," *Los Angeles Times*, June 9, 1999, p. A11.

[55]Wayne Arnold, "New Indonesian Leadership Stirs Financiers' Skepticism," *New York Times*, October. 27, 1999, p. C4.

[56] See ibid.; also Solomon, "Indonesia's Chinese Move to Increase Civil Rights After a Decades-Long Ban on Political Activities," p. A14; Velloor, "Fix Chinese Issue, Indonesia Told," p. 2; Yamin, "Economy–Indonesia: Not Too Happy With Very Strong Currency."

coincidence that President Wahid's first official visit was to China, where one of his primary goals was to secure Beijing's blessing for the return of "overseas Chinese" capital to Indonesia.[57]) But for these pro-market policies to succeed would require a degree of assurance of Chinese economic security, that may not be compatible with a genuine democratic politics in a country where, just twenty months ago, many reportedly felt that "it would be worthwhile to lose ten years of growth to "get rid of the [Chinese] problem once and for all."[58]

[57]Porter, "Wahid Starts Drawing Home Lost Billions," p. 10; "Chinese New Year to Be Publicly Celebrated," *Jakarta Post*, January 17, 2000.

[58]Velloor, "Fix Chinese Issue, Indonesia Told," p. 2.

POLICY IMPLICATIONS

The foregoing discussion suggests a number of policy implications for the prospects of neoliberal reform in Indonesia. Consider the following:

1. *Ethnoeconomic Effects of Marketization.* Conventional wisdom implicitly assumes that market reforms coupled with anti-corruption initiatives will solve (or at least ameliorate) the problem of the economically dominant Chinese minority in Indonesia by "leveling the playing field." This assumption is overly simplistic—and almost certainly wrong. Corruption and political favoritism (for example, in the form of *cukong* or patronage relationships) have clearly contributed to the enormous wealth of some Sino-Indonesians. However, treating such favoritism as the "explanation" of Chinese economic dominance begs the question of *why* those in power have chosen repeatedly to collaborate with the Chinese. The decision of so many indigenous leaders in Southeast Asia (among them, Suharto, Ferdinand Marcos in the Philippines, the Nguyen emperors in Vietnam, and a host of Thai kings) to enter into lucrative, symbiotic commercial arrangements with the Chinese is not fortuitous. Rather, it reflects, at least in part, the long-standing success of the Chinese as a wealth-generating "middleman" minority.[59] It is important to remember that Chinese economic dominance in Indonesia predates Western "divide-and-conquer" policies. Equally important is that historically many economically successful Sino-Indonesians did *not* profit from political favoritism (and indeed suffered official economic discrimination), and that the Indonesian Chinese under Suharto were economically dominant at all levels of society. In other words, if history is any guide, Chinese Indonesians are almost certainly a market-dominant minority—one whose stark economic dominance will not necessarily dissipate, and indeed may even increase,

[59] See Chua, "The Privatization-Nationalization Cycle," pp. 31–32, 101–2.

with privatization, pro-competition policies, and other market-oriented neoliberal reforms.

2. *Ethnopolitical Effects of Democratization*. Indonesia faces numerous challenges as it democratizes, including the rapidity of the process,[60] the country's deep ethnic divisions, and the glaring wealth gap between the historically resented Chinese minority and the generally impoverished, indigenous *pribumi* majority. As one commentator presciently warned before Suharto's resignation, particularly because of Indonesia's limited democratic experience, excessively rapid democratization might "release a myriad of long-suppressed demands by aggrieved groups; these might destabilize the political system and lead to the reimposition of authoritarian rule."[61] Moreover, as in all ethnically divided societies, electoral campaigns can be expected to give rise to ethnic politicking and demagoguery by opportunistic, vote-seeking politicians. (During the period leading up to the 1999 election, the Islamic right "attacked Megawati as not really a Muslim but some sort of Javanese Hindu, beholden to Christians and Chinese, possibly a crypto-Communist.") In particular, anti-Chinese, ethnonationalist rhetoric can almost certainly be expected, especially if the stark ethnic wealth gap is not narrowed. It is crucial for policymakers to keep in mind that, taking universal suffrage as a given, democratization can vary along a large number of axes relevant to the paradox of free market democracy: to name a few, presidentialism versus

[60]As I have discussed elsewhere, the process of democratization that developing countries are being asked to embrace is *not the same as the one the Western democracies themselves went through*. In the West, universal suffrage emerged only very gradually and incrementally: All of the Western nations had massive exclusions from the suffrage, as a result of longstanding property ownership and other qualifications on franchise. By contrast, in countries like Indonesia, universal suffrage is being implemented on a massive scale and almost, by comparison, overnight. This sudden process of democratization makes the transition to free market democracy particularly volatile. See Chua, "The Paradox of Free Market Democracy: Rethinking Development Policy," pp. 311–12.

[61]Liddle, "Coercion, Co-optation, and the Management of Ethnic Relations in Indonesia," p. 319.

parliamentarism; "first-past-the-post" versus proportional representation; starting locally versus starting nationally. President Wahid recently announced that "his Government would propose [that] the country's next president be elected directly by the people."[62] While Wahid's promise to "respect the opinion of the people" was received with popular euphoria, much more consideration needs to be given to the question of what kind of democracy is suitable to Indonesia in light of the tensions that will inevitably arise between markets and majoritarian politics.

3. *Creating Interethnic Stakeholding in a Market Economy*. The real challenge for neoliberal reform in Indonesia will be to secure the return of Chinese-controlled capital and to harness the economic skills and connections of the Chinese while at the same time giving the impoverished, newly enfranchised *pribumi* majority a genuine, sufficient stake—material, political, and psychological—in a market economy. At some level, the Sino-Indonesians understand this. As one commentator recently put it,

> [t]he country's ethnic Chinese will be especially watching to see how the new government goes about narrowing the country's wealth gap. Both Mr. Wahid and Ms. Megawati have been opposed to taking from rich ethnic Chinese. Yet both acknowledge that if they are to eradicate anti-Chinese sentiment among the masses, the economic gap needs to be narrowed. . . How the new cabinet goes about addressing this sensitive issue, without scaring off future ethnic Chinese investment, remains one of the big unanswered questions.[63]

Along these lines, a useful counterpoint to Indonesia is provided by neighboring Malaysia, where, since the Asian financial crisis erupted two years ago, there has been (in striking contrast to

[62]At present, Indonesia's "president and vice-president are elected for a five-year term by the MPR, composed of 462 elected MPs, 38 military appointees, and 200 appointees representing the regions and non-political organisations. Under the country's two-tier political system, the PDI-P won last year's parliamentary election but its leader, Megawati Sukarnoputri, did not automatically become president." See "Wahid proposes direct poll to create 'people's president'," Agence-France Presse, March, 28, 2000.

[63]Porter, "Wahid Starts Drawing Home Lost Billions," p. 10.

Indonesia) no anti-Chinese reaction or ethnic rioting, no discriminatory ethnically-targeted market intervention,[64] and very little capital flight.[65] Part of the explanation for this is clearly Malaysia's New Economic Policy (NEP). Although the NEP has always been very controversial and problematic in a number of respects, most contemporary analysts agree that Malaysia's systematic interventions during the last thirty years have almost certainly helped "integrate and harmonize a potentially volatile population,"[66] by giving the economically disadvantaged Bumiputra majority a stake in the overall market economy and by dulling the appeal of ethnonationalist, anti-market extremism.

I have elsewhere discussed the NEP in detail.[67] Here I will only summarize.

Following the 1969 race riots in Kuala Lumpur, which were similar in many respects to the 1998 riots in Indonesia, the Malaysian government adopted the NEP, aggressively seeking to achieve "'national unity . . . expressed as the improvement of economic balances between the races.'" Starting in 1969, the Malaysian government implemented strong preferential measures for the Bumiputra majority in sectors such as corporate ownership, education, business, employment, credit, and civil service administration. For example, after 1976, under what was effectively compulsory corporate restructuring, many Malaysian Chinese companies were required to set aside 30 percent of their equity for Malay interests (typically

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[64]During the recent financial crisis, Prime Minister Mahathir Mohamad of Malaysia took pains to praise the Chinese community for contributing to the strength of the national economy with their "wisdom and efficiency." See Adeline Ong, "Be Disciplined to Ensure Growth," *Business Times* (Malaysia), March 8, 1999, p. 2. On the other hand, Mahathir blamed Malaysia's economic problems on foreign "'rogues,' 'morons,' 'neo-colonialists,' and an imagined conspiracy of Jewish currency traders." See Seth Mydans, "Hard Times Weaken a Malaysian Powerbroker," *New York Times,* October 23, 1997, p. A12.

[65]The capital controls imposed by the Malaysian government in September 1998 did "not unleash the troubles many people initially feared. No black market . . . emerged and capital flight [was not] a problem." S. Jayasankaran, "Malaysia: Return of Optimism," *Far Eastern Economic Review*, vol. 61 (March 18, 1999), p. 61.

[66]Steve Glain, "Malaysia's Grand Social Experiment May Be Next Casualty of Asian Crisis," *Wall Street Journal*, April. 23, 1998, p. A15.

[67]See Chua, "The Paradox of Free Market Democracy: Rethinking Development Policy," pp. 351–53, 355–59.

with no choice about the Malay recipient of such equity). At the same time, the government "invest[ed] heavily in publicly owned corporations that were operated and managed by Malays"; it also "created a number of incentive schemes to attract private Malay investment to these enterprises." With respect to education, the Malaysian government implemented sweeping reforms, including preferential quotas and scholarships for Bumiputra and the establishment of elite boarding schools set up exclusively for Malays. In addition, quotas were set for the employment of Malays in commercial and industrial firms, and non-Malay firms, including foreign corporations, "were asked to devise plans for the training and promotion of Malays to more skilled and upper management positions."[68]

It is safe to say that the NEP failed to achieve some of its most ambitious objectives. Despite inflated official claims, for example, the NEP has not succeeded in "eradicating poverty," one of its major goals. Moreover, even after decades of sustained governmental intervention, the Chinese minority generally remains economically dominant vis-à-vis the Bumiputra majority.[69]

Nevertheless, if the goal of the NEP is seen not as achieving "economic parity between the races," but rather as promoting interethnic stakeholding and thereby helping to negotiate the paradox of free-market democracy in the face of a resented, market-dominant minority, then the NEP may well have been extremely successful. While the NEP has not lifted the great majority of Malays (particularly in the rural areas) out of poverty, it has helped to create a substantial Malay middle class. Between 1970 and 1992, the percentage of Malays occupying the country's most lucrative professional positions went from 6 percent to 32 percent. Specifically, during roughly that period, "the proportion of Bumiputra doctors rose from 4 to 28 percent, dentists from 3 to 24 percent, architects from 4 to 24 percent, engineers from 7 to 35 percent, and accountants from 7 to 11 percent." In the corporate sector the Bumiputra ownership share of corporate stock at par

[68]See ibid. (citations omitted).
[69]See ibid. (citations omitted).

values jumped from 1.5 percent in 1969, to 15.6 percent in 1982, to 20.6 percent in 1995. "There is no possibility that market mechanisms could have produced such results."[70]

By creating a small but visible Malay economic elite and by bringing Malay participation into important economic sectors—for example, the construction, rubber, tin, shipping, banking, and communications sectors (all formerly dominated by foreigners or Chinese and Indian Malaysians)—the NEP has helped to promote a sense among the Bumiputra that a market economy can benefit indigenous Malays, and not merely foreign investors and entrepreneurial "outsiders." Today, in addition to the many Malay "tycoons," "[s]ome of the best medical specialists, lawyers, and architects in Malaysia today are Malay"—a fact acknowledged even among the Chinese, who in the 1960s "viewed the Malays with condescension at best, scorn at worst."[71] Mahathir Mohamad's recent reelection (which dismayed many Western observers, because of his abysmal free-speech record) is significant in a number of respects. Polls suggest that most Malays approve of Mahathir's ethnic policies. Moreover, Mahathir had the support of large numbers of Chinese Malays, including many influential members of the business community.[72]

From this point of view, it becomes much harder to conclude that Malaysia's NEP has been inefficient or "growth-retarding." On the contrary, to the extent that ethnically based market interventions help reconcile poor majorities to the inequities of a market economy, they provide a horizon of social stability for the implementation and oscillations of a market system. Thus, they arguably are a plausible way not only of reconciling democracy and markets, but also of promoting long-term investment and economic growth.

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[70]Milton J. Esman, "Ethnic Politics and Economic Power," *Comparative Politics*, vol. 19 (1987), p. 406; see Chua, "The Paradox of Free Market Democracy: Rethinking Development Policy," pp. 351-53, 355–59 (citations omitted).

[71]See Chua, "The Paradox of Free Market Democracy: Rethinking Development Policy," pp. 356–57 (citations omitted).

[72]See ibid., p. 359 (citations omitted).

4. *Limits of Current Rule-of-Law, State-Building, Judicial-Reform, and Civil-Society Initiatives in Indonesia*. The design of all the latest reform initiatives in Indonesia (including promotion of the rule of law, state-building, independent judiciaries, and civil society) must be re-examined in light of the paradox of free-market democracy and Indonesia's particular ethnic demographics. All of these reforms are of great importance for Indonesia (as throughout the developing world). However, they are not panaceas. Indeed, if care is not taken, these initiatives could inadvertently heighten the conflict between markets and democracy. For example, the main thrust of today's rule-of-law projects in the developing world is to facilitate market activity and foreign investment, by strengthening legislative and judicial protections of property and contract. But historically foreign investors have dealt principally with Sino-Indonesians (because they represent most of the commercial class and control most of the private sector). Therefore, it is the latter who tend to benefit directly from foreign investment liberalization, while the great majority of the *pribumi* are left to wait for the trickle-down benefits of foreign investment. Thus, to the extent that today's rule-of-law initiatives succeed, they will accomplish very significant achievements, but in the process they may intensify the contest between majoritarian politics and unequal, ethnically concentrated wealth.

Similarly, it is important to recognize the limits of, and dangers inherent in, today's state-building initiatives in Indonesia. Because of Indonesia's demographics, there is a powerful tendency toward what scholars have called an "ethnocratic state," one that acts as the agent of a dominant ethnic group with respect to ideology, social policy, and resource distribution. In Indonesia's case, all the principal arms of the state—the executive, legislature, judiciary, civil service, police, armed forces, etc.—historically have been dominated by the *pribumi* majority (in particular the Javanese) and used to reinforce that group's monopolization of power. In these conditions, state-building becomes a more complicated, and even dangerous, proposition. All the institutions associated with state-building can serve as vehicles for ethnocratic entrenchment, exclusion, and even brutality. (Note that an independent judiciary can also be an intolerant, ethnonationalist judiciary; this was the case in Weimar Germany, as I discuss elsewhere.[73]) It is thus a grave mistake to think of ethnic conflict as a problem to be addressed *after* the process of state-building is successfully completed. Rather, the challenge is to try to structure developing-country political institutions in such a way as to avoid ethnocracy and to promote *interethnic* solutions and institutions to the extent possible. President Wahid has impressively taken steps in this direction. For example, he has included in his cabinet members of traditionally unrepresented ethnic and regional groups, including a Sino-Indonesian minister to oversee economic policy. Measures along these lines are crucial if Indonesia is to enjoy the kind of ethnic stability necessary to provide a stable horizon for neoliberal reforms to succeed.

Finally, in ethnically divided countries like Indonesia, it is entirely possible for civil society to be just as ethnocratic as the state. For example, in certain circumstances unionization or other forms of labor organization can become a vehicle for highly polarized ethnic confrontation. In Indonesia, the early 1990s saw the rapid growth of the *Serikat Buruh Sejahtera Indonesia* (SBSI), "an independent labor union that challenged the monopoly of the [Suharto] government's own corporatist union."[74] The Suharto government suppressed the SBSI "after a massive labor protest in Medan, North Sumatra, in April 1994 turned into a riot against the Sino-Indonesians."[75]

5. *Objectionable Practices by the Sino-Indonesian Minority.* It is unfortunately the case that some members of the Chinese community in Indonesia engage in practices—for example, bribery and corrupt patronage relationships—that not only are illegal or objectionable in themselves, but also reinforce invidious ethnic stereotypes and fuel bitter resentment among the indigenous majority.

[73]See Chua, "The Paradox of Free-Market Democracy: Rethinking Development Policy," pp 330–38.

[74]Liddle, "Coercion, Co-optation, and the Management of Ethnic Relations in Indonesia," p. 318.

[75]Ibid. Even after the SBSI was suppressed, "the number of localized wildcat strikes, particularly against companies producing for export, continue[d] to grow."

The anti-Chinese violence that erupted in Indonesia May 1998 was inseparable from the association of a few Chinese magnates with the Suharto regime's "crony capitalism."[76] As is sadly often the case, violent popular reaction unleashed itself not on the relatively few wealthy Chinese who were actually complicit (and who used their wealth to go into hiding abroad), but rather on ordinary, struggling, middle-class Chinese Indonesians, whose shops were burned and looted.

It is not, however, only the wealthiest members of economically dominant minorities who engage in illicit practices. Regrettably, the problem is more general. In Indonesia, as throughout Southeast Asia, many Chinese-controlled firms routinely violate tax laws, banking laws (including restrictions on self-lending and discriminatory lending[77]) and "laws concerning overtime regulations, workers' compensation and protection, occupational health and safety requirements, and building codes."[78] The illegal importation of cheap labor from China is a particular problem. Throughout Southeast Asia, there have been complaints about the influx of "tens if not hundreds of thousands of illegal migrant workers from the PRC, most of whom are likely to be employed in small, Chinese-owned enterprises."[79] As in the developed world, "local workers resent the competition [from illegal immigrants] and the resulting downward pressure on their wages."[80] In Indonesia, where roughly six million working age Indonesians (almost all *pribumi*) were unemployed in 1996, the violent protest that erupted when a Chinese conglomerate imported one thousand illegal workers from China seems understandable. The perception among an economically disadvantaged majority that a disproportionately wealthy

[76]Vatikiotis, *Indonesian Politics* Under Suharto, pp.14, 41, 45, 50.

[77]Ibid. pp. 41.

[78]K. S. Jomo, "A Specific Idiom of Chinese Capitalism in Southeast Asia: Sino-Malaysian Capital Accumulation in the Face of State Hostility," in Chirot and Reid, eds., *Essential Outsiders*, pp. 252.

[79]Ibid. pp. 293.

[80]Ibid.

minority disregards the country's laws and exploits the indigenous population can only exacerbate ethnic resentment.[81]

What to do about such illicit practices is less obvious. To begin with, there is often a collective-action problem. If any single firm decides to comply with workplace and other regulations and its competitors do not, that firm will likely go out of business. Thus, calling on individual businesses to take corrective measures is unlikely to have much effect. On the other hand, looking to the state is not a complete answer either. One obvious problem is that the governmental actors who would have to implement reform are often the same ones corruptly benefiting from the violations (through kickbacks or bribes). An as-yet unexploited resource here may be the surprisingly strong intra-ethnic organizations, both commercial and social, that many economically dominant minorities already have in the developing world. The success of these organizations in overcoming collective-action problems in a variety of commercial contexts—through a combination of "trust" and superior monitoring capacities—has been widely observed. If leaders of the minority communities in a given developing country can be persuaded of the importance of, and overall gains to be had from, eliminating corrupt or illicit business practices, these organizations may have the right set of incentives and capabilities to play a significant role.[82]

[81]See Chua, "The Paradox of Free-Market Democracy: Rethinking Development Policy," pp. 373–76.

[81]See ibid, pp 374–75.

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