

# Institutions and the Political Economy of Corruption in Developing Countries

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## 1 The Problem

This is a discussion paper that uses Indonesia's experiences to explore some arguments about the ways in which political institutions bear upon the dynamics of corruption in developing countries. It works at the edges of two of the best-established ideas on corruption: that corruption is a drag on economic development, and that democratic governance is a critical ingredient in containing corruption. Simply stated, the former holds that investors, particularly private investors, require independent and effective legal institutions to contain corruption and secure their property rights. If contracts cannot be enforced in a reasonably consistent way and if governments are not constrained from acting corruptly or capriciously, the risks to potential investors are likely to become prohibitive. Rapaciously corrupt environments are thus widely understood as inhospitable to investment, and thus growth. Similarly, it is also now widely accepted among scholars and practitioners that, over time, democratic governance arrangements provide the best environment for containing corruption and securing property rights. Democratic frameworks make the operations of government more transparent, increase the scope for holding politicians accountable for their actions and allow independent judicial systems to operate. These two basic ideas are closely linked and rest upon strong logics rehearsed in a now large theoretical literature, and an increasingly sophisticated body of empirical evidence. This paper explores the possibility of property rights being secured – or at least tolerably secure – in environments where democracy is weak or non-existent and where the judiciary is either controlled or corrupted.

Indonesia is a remarkably interesting case through which to view these issues. Like a number of other Asian economies that experienced sustained rapid economic growth during the latter

twentieth century, Indonesia attracted rates of private investment significantly above the average for developing countries.<sup>1</sup> During the three decade rule of former president Suharto (1966-98), Indonesia displayed a combination of autocratic politics, pervasive corruption and rapid economic growth. This is intriguing. That autocratic politics should be associated with pervasive corruption is scarcely surprising. That these two should be associated with strong investment and rapid economic growth over more than a quarter of a century is deserving of attention. All the more so once we allow that Indonesia's experience is by no means unique.

Why would private investors -- whether local or foreign -- risk their money in a setting where the legal system was of such doubtful standing that Supreme Court justices ridiculed their colleagues as being hopelessly corrupt, where the President himself acknowledged that the legal system was beset with deep-seated problems of corruption, and more pointedly, where business people largely abandoned the notion that the legal system was an effective vehicle for arbitrating commercial disputes? Beyond well-recognized problems with its formal legal system, under Suharto Indonesia also had a reputation for systemic cronyism and corruption in the administration of government. In the latter years of Suharto's rule endless complaints were directed at the rapacious rentier business practices of his children, grandchildren, and business associates as well as the off-spring and associates of other senior officials. But this was scarcely a new phenomenon; if one were to scan the pages of the press ten or twenty years earlier one would encounter the same complaints about an older generation of players. In short, although many of the characters surrounding Suharto had changed, the same basic pattern had been in place since the early days of the regime. Indeed, the literature on Indonesian political economy

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<sup>1</sup> MacIntyre 2001 provides data. This discussion paper draws directly on MacIntyre 2001.

groans under the weight of anecdotal evidence of pervasive clientelism and corruption (Robison 1986; Muhaimin 1991; Schwarz 1994; Winters 1994).

Private investors operating in Indonesia -- ranging from U.S. telecommunications companies, Japanese car manufacturers, and Canadian gold mining companies through to large Indonesian construction companies and small Indonesian rice farmers, all had to grapple with the importance of political connections. Although there was some sectoral variation, in general the better one's connections, the greater one's chances of securing the plum deals, obtaining preferential regulatory treatment, and escaping inconvenient contractual obligations. Conversely and more worryingly, the weaker one's connections, the more vulnerable one was to falling victim to the predatory trading practices of those who are well-connected. Such practices range from financial imposts to forced mergers and takeovers. It is scarcely surprising then that the international indexes of national corruption consistently gave Indonesia a very low ranking. And yet, as we have seen, in spite of the negative effects one might expect this to have on risk assessments and calculations about the cost doing business, foreign and local firms continued to invest strongly in Indonesia. How do we explain this?

In what follows, I use Indonesia's experiences under Suharto and since to illustrate some ideas and build an argument in favour of a more cautious approach by both scholars and practitioners than is common about the connections between institutions, governance and corruption.

## **2 The Argument**

I propose an explanation that focuses on the institutional environment and the nature of governance, and explores the incentives facing political leaders. I do this by drawing on and adapting the work on corruption by Shleifer and Vishny (1993). They draw an analogy from industrial organization theory to model the consequences of the political and institutional environment on the level of corruption and the extent to which it inhibits investment and economic growth. The underlying model is that of Augustin Cournot's (1838) complementary monopolies, namely a contrast between the pricing decisions of a single monopolist who produces strongly complementary goods and multiple independent monopolists each producing only one of the strongly complementary goods. The single monopolist will have an incentive to price his goods in a concerted fashion, because pushing up the price of one of his goods will tend to push down demand for the others since consumers require all. Conversely, where there are multiple independent monopolists, even though the goods remain strongly complementary, they will tend to push up the price of their respective products and all will suffer because they are in a prisoners dilemma type situation.

Shleifer and Vishny take this insight and apply it to corruption, by focusing on bribery and the market for government regulatory goods (ie. licenses and permits needed by firms to do business). They assume there are multiple regulatory goods involved and there is strong complementarity among them all (so that potential investors will need a building permit, and an import license, and an employment contracts etc). For present purposes, the relevant point is the contrast they draw between two stylized models of the market for government regulatory goods under authoritarian or weakly democratic political conditions and where corruption is rife (and, by implication, legal institutions are weak); one highly centralized, and the other much less

so. In the first, national political leadership exercises sufficiently strong grip on regulatory agencies that we can think of the relevant sections of the state as functioning in a fashion approximating that of a single centrally coordinated monopoly for bribe-collecting. Strong political leaders are able to prevent regulatory agencies from acting independently and to ensure that a healthy share of bribes collected flow upwards, with the remainder being distributed proportionately among relevant officials at the coal face. In short, officials in regulatory agencies are unable to operate independently to maximize their own take. Under this model, if a firm is seeking the necessary permits to, say, establish a factory, once it has provided the appropriate corrupt inducements, it acquires secure property rights to the package of regulatory 'goods' it has purchased.

The second model is one in which political control is weaker and less centralized. Instead of there being a situation approximating a single monopolist, there is a multitude of independent monopolists selling complementary regulatory goods. Because the political leadership is unable to exercise effective control over bureaucratic agencies, officials (and/or their respective agencies as a whole) seek to maximize their own take by acting as independent monopolists and pushing up prices without regard for the effect on overall demand for government goods. Also, unlike the single monopolist model, in this situation the firm purchasing all these government goods can never be sure it has secure property rights as any agency might subsequently seek to extract further bribes. The weaker the political leadership's control, the greater the scope for independent and uncoordinated extraction by officials pursuing their own individual interests. Moreover, if the leader is not confident that coordination can be enforced, his or her best

interests are served by acting as an independent monopolist too and competing directly with all other officials. (Crudely, if you can't beat them, join them.)

The key insight to be drawn from Shleifer and Vishny is that there may be an important analytical distinction to be drawn between situations in which corruption is pervasive but the framework of government is tightly centralized and those in which it is only loosely centralized. If the leader enjoys strong control over regulatory agencies, then we can think of his or her interests on the pricing of bribes as being equivalent to those of the single monopolist under conditions of strong complementarity. As such, he or she has a direct interest in imposing coordination and ensuring that no individual agency enriches itself at the expense of the system of as a whole, and the political leadership in particular. On the other hand, where the leader enjoys only weak control over regulatory agencies, officials will be far less constrained and facing the incentive structure of the independent monopolists under conditions of strong complementarity, they will seek to maximize their own takes by driving up the bribes necessary to obtain the particular regulatory goods that they control, even though this will drive down overall demand. According to this logic although corruption is pervasive in both, strongly centralized government will produce the lower individual bribes, but the higher level of overall rent collected (because more bribes will be collected), whereas loosely centralized government will produce the higher level of individual bribes, but the lower overall rent collection (because less bribes will be collected). And, more importantly from an overall economic viewpoint, corruption under conditions of loosely centralized government will be more injurious to economic growth because it will reduce economic activity by driving down demand for the government goods necessary firms to go about their productive business. Note the

counterintuitive result here, under conditions of strong centralization there will be more bribes collected and higher total revenue extracted by from the private sector, but less damage will be done to the economy because the bribes will not be priced excessively (that is, they will not drive down demand significantly).

Shleifer and Vishny's insight into the pricing of bribes and, by extension, the security of property rights, is a powerful one. To operationalize it, however, we need to dissect more carefully the political preconditions for these stylized models they sketch. To think of a single monopolist simply as a strong or centralized government is to slide too quickly over key details. A spectrum of governments in the non-democratic world would fall under this heading, and yet fail to behave according to expectations. The key issue is not regime-type, but the institutional capability of the leader to minimize problems of agency loss – officials behaving in a manner contrary to the leader's wishes. While there is a range of mechanisms by which agency loss can be alleviated (Kiewiet & McCubbins 1991), in practice in most developing country contexts monitoring and enforcement are pivotal. Given that no leader can directly control all decisions on the sale of regulatory goods, his or her ability to minimize problems of agency loss will depend on the leaders ability to know whether their errant behavior is taking place and then to deter it. Many leaders – particularly in authoritarian settings – have an ability to punish; much less common is an ability to monitor effectively. Accordingly, few political leaders are in situations which give them the ability – and thus the incentive – to enforce 'coordination' among their rent-harvesting agents. Not surprisingly then, unpredictable and destructive patterns of corruption (the multiple independent monopolists) are very common in developing countries.

I argue that Indonesia was able to escape this common syndrome because for many years the political and institutional framework was a remarkable approximation of the economically less destructive single monopolist model. The political framework developed under Suharto did indeed centralize power heavily around the president and gave him a credible capability for monitoring the behavior of his agents in the bureaucracy and punishing those that deviated significantly from his core preferences.

In terms of formal government institutions: the constitutional framework tilted power massively in favor of the president (MacIntyre 1999). Although there were regular elections for the legislature, the government had the authority to vet all candidates, including party leaders. Elections were managed in an elaborate system that biased things heavily towards the government party and more particularly the executive (including appointing military officers to 20% of seats). Not surprisingly, although the legislature had the right to initiate and amend or block legislation, in practice it never did. Further, the president had very wide ranging decree powers.

In terms of the civilian bureaucracy - which is the point of sale of regulatory goods - not only did the president have direct hire and fire power over all senior appointments (in all agencies, state enterprises, and the judiciary), he also had effective formal monitoring mechanisms such as military or ex-military officials (as Inspector Generals) in all public institutions who reported back to the office of the presidency. The armed forces were the most politically sensitive section of the bureaucracy. Here too the president had appointment powers on all significant positions (actively involving himself in decisions at least as far down the organizational hierarchy

as colonel). In addition, however, precisely because of the central importance of the armed forces in Indonesian political life, all senior positions were subject to regular rotation.

In the terms of the institutionalist literature concerned with agency problems, all of these formal monitoring mechanisms were of the “police patrol” variety, that is institutions designed to detect and report violations (McCubbins & Schwartz 1984). Less formal, but also potentially valuable were “fire alarm” networks, that is arrangements where by third parties could alert the political leadership to an outbreak of problems. Perhaps the most important of these was the fact that very many local and foreign firms would have one or more politically connected individual – such as a former military officer or senior official – directly or indirectly affiliated with them. (Local firms, being predominantly Chinese Indonesians, did this for political protection; foreign firms for protection as well as for local information.) If a firm encountered seriously capricious action by officials that jeopardized operations, it could use its connections to convey its grievances to higher authority through informal military and bureaucratic networks.

The empirical point to be made here is that Indonesia's political architecture centralized power around the presidency; all relevant players owed their positions directly to the president, and he maintained effective monitoring capabilities of administrative behavior and, very clearly, effective enforcement capabilities. This is not to suggest that Indonesia had a finely tuned and efficiently coordinate bureaucracy -- plainly this was far from the case. Nor is it to suggest that these various oversight mechanisms were used for the primary purpose of detecting excessively corrupt officials – again, this was plainly far from the case. Simply, my purpose is to argue that unlike many authoritarian leaders, Suharto did have access to quite extensive information about

the behavior of regulatory agencies and did have the ability the ability to punish officials whose behavior deviated significantly from his core preferences.

Suharto did not have to intervene often to keep the system going: periodic demonstrations were sufficient. A striking illustration was the sudden and dramatic presidential decree to disempower the entire customs bureau in 1985 when corruption on the waterfront became a serious problem. Overnight, that bureaucratic function was instead delegated to a Swiss company (Nasution 1985 pp. 13-4). In 1986 when it became apparent that the textile industry was being jeopardized by an overly greedy cotton import monopoly, executive action led to the disbanding of the monopoly and the firing of senior officials (MacIntyre 1991 ch. 4). In 1996 when corruption problems in the transport ministry became too blatant, the minister was ultimately permitted to retain his position, but only after being subjected to public humiliation. None of these interventions was designed to *eliminate* corruption – the entire regime was built upon maximizing corruption – but all had the effect of *curtailing* corruption that had become sufficiently costly or disruptive as to pose a serious threat to continued investor confidence in that sector. Suharto was in a position whereby he could maximize his own interests by allowing bounded corruption to flourish. The bounds were what the market would bear. A plethora of monitoring mechanisms kept him sufficiently informed if serious problems emerged and his far reaching powers enabled him to deal with greedy or unreliable officials who endangered the system. To be sure, the system was neither foolproof nor refined (as illustrated by any number of anecdotes from investors who *did* become disenchanted). My contention is that there was a rough system of oversight and enforcement that worked sufficiently well to keep a remarkable number of investors sufficiently happy for a remarkably long period of time. This system

produced both welcome and unwelcome outcomes: investment and economic growth were remarkably strong, and corruption penetrated almost every part of the economy.

If Indonesia's formal political institutions provided the president with substantial monitoring and enforcement capabilities, its informal institutions gave him a strong incentive to maximize the flow of rents up to his office. Permeating Indonesia's formal political institutions was a vast informal network of patron-client relationships through which coursed much of the life-blood of political life. Suharto was the paramount figure in this network. Crucial to the sustenance of this hierarchical support network was his ability to distribute patronage, most notably money. Thus in addition to any personal accumulatory impulses, the president had a fundamental interest in maximizing the discretionary resources that flow up to him, as they were critical to his political survival.

Institutionally, then, the position of Suharto was much like that of the single monopolist. That is, he had the ability and incentive to enforce coordination on the pricing of bribes and preservation of property rights of investors, thereby ensuring both the maximization of the rents captured for his own use, and an environment of predictability for investors with regulatory goods being supplied at a price the market would bear.

The Shleifer and Vishny model offers important insights into why a political leader in a strong position has an incentive structure to ensure that the pricing of bribes and the incidence of capricious action are tempered by what the market will bear. Fleshing this out, we can see that the incentive structure was dependent upon the institutional setting. For both theoretical and

empirical reasons, my explanation of the Indonesia puzzle does not stop here. I go a further step since incentives – even strong incentives – do not of themselves guarantee that a leader will consistently follow a particular course of action. In situations where power is very heavily concentrated, leaders can alter or even reverse course at any time. In the absence of any meaningful institutional constraint, there is unlikely to be anything to stop them. And here of course we come up against the time consistency problem and the issue of credible commitments. Even though it may be in the interest of the leader to ensure moderation in the pricing of bribery and capricious behavior by officials, when power is so massively concentrated, when judicial, legislative, and regulatory veto-points are so scarce, what confidence can investors have that he will in fact do so for the life of their investment plans? How can investors have confidence that the government has a fundamental commitment to ensuring a tolerable business environment?

In Indonesia's case, I argue that the final piece in the puzzle was the existence of a remarkably effective commitment mechanism. This was the decision taken in 1970 to open the capital account and make the currency fully convertible. This was critical in two respects. First, given the country's dismal economic record up to the mid-1960s, opening the capital account seems likely to have been pivotal in reassuring investors (both foreign and local) that they could get money out of the country if things went wrong. Secondly, and in the longer run probably more important, in adopting this measure (well before most other developing countries) the government was effectively tying its own hands. The open capital account created a powerful early warning system of investor discontent which would exercise a powerful discipline on government behavior. By allowing capital to move freely, the government was, in effect,

enabling investors to punish it if the business environment deteriorated. Unlike other aspects of its economic policy behavior this commitment to guarantee an acceptable business environment had strong credibility. Although the opening of the capital account had only the status of a decree and was thus, in principle, easily changed, in practice it would be extremely costly to revoke. Abandoning it would be a massive disincentive to further investment; with collapsing investment creating very sharp economic and ultimately political costs for the government. More than any other single policy measure, this signaled a commitment to investors. It was a nearly irrevocable act of self-regulation which provided grounds for broad confidence about the overall nature of the policy environment.

To summarize the argument thus far, I have been concerned with the puzzle of why, for roughly three decades, Indonesia was able to generate strong investment flows and economic growth when its legal institutions were so weak and corruption so widespread. Building on the logic laid out by Shleifer and Vishny, I argue that we can see the political and institutional circumstances of Suharto's Indonesia were such that they gave the leader a powerful incentive to ensure that bribes were not priced excessively and that arbitrary behavior was contained within tolerable limits. In short, to ensure that corruption was conducted in an orderly fashion that was within the limits of what the market would bear. Note that this economic incentive structure was dependent upon a political structure and a set of formal and informal institutional mechanisms which reduced agency loss by permitting effective executive oversight and punitive action. This provides with us a plausible explanation as to how and why Suharto was able to ensure that while corrupt practices flourished, it did so within limits tolerable to investors. But this argument also introduces something of a paradox, for the very institutional conditions which

underpinned the president's ability and incentive to maintain orderly and market-consistent corruption, also made government policies of uncertain future since they were so easy to reverse. That is, the very factors which encouraged the president to ensure moderation also had the potential to increase risk for investors. The final step of my argument tackles this problem by focusing on alternative institutional mechanisms for promoting investor confidence about future patterns of governance. In the absence of either political institutions that can check arbitrary behavior or an independent legal system other forms of guarantees to investors about the future are possible. In Indonesia's case,, the opening of the capital account in 1970 provided a powerful approximation of such a credible commitment. Consciously or otherwise, this quickly came to be a strong constraint on future policy action. Because it was such a potent symbol to investors, the costs of reversing the rule became extremely high. Here, then, was a regulatory commitment upon which investors could reasonably begin to plan, since in a fundamental sense, the government was tying its own hands.

I close out the discussion of the Indonesian case by reflecting on what has taken place in Indonesia since Suharto's demise. As is well known, the regime crashed amidst the economic rubble of the Asian economic crisis. What has transpired since in Indonesia is revealing, and bears brief recounting. The essence of the story is that following Suharto's fall, three successive presidents have been committed to building a democratic framework of government and curbing corruption. There were high hopes inside and outside Indonesia for a new democratic dawn and a reining in of corruption. In fact, by general agreement, Indonesia's corruption problems have become and more destructive.

A quick glance at that institutional environment that has emerged since 1998 is enough to explain why. The particular democratic configuration hammered out by reformers in the wake of Suharto's fall has had the effect of severely fragmenting power, with the president now being beholden to a multiparty legislature not just for its cooperation in law-making, but for his/her appointment and continued survival in office.<sup>2</sup> We do not need to be detained here by the details of the new framework to appreciate the main implication: the president has been in no position to enforce his/her will on cabinet ministers – for they came from a variety of parties and, collectively, these parties controlled the fate of the president him/herself. With ministerial accountability being divided between the president and the minister's party colleagues, agency loss was always likely to be high. Another whole set of agency problems existed between ministers and the bureaucrats beneath them. And to further cloud the picture, at the same time as politicians at the national level struggled with this extremely convoluted framework, a major devolution of power was also underway from national government to regional and local government.

In short, within a brief period, the structure of government in Indonesia has undergone radical change. Importantly, this change in the country's political structure has been taking place in context of a still very weak legal system. To be sure, the judiciary is no longer a puppet of the government, nevertheless it remains of little value to investors (or anyone else) as an objective arbiter and interpreter of the law. This is because the judiciary is utterly and very conspicuously

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<sup>2</sup> NDI various, MacIntyre 2002.

corrupt.<sup>3</sup> It is widely understood that cases are, as a matter of course, bought. The tribulations of the Canadian insurance company, Manulife, provide a high profile illustration of this (ref).

To summarize, in this environment there was no possibility of the legal system being an effective avenue for investors to secure contractual property rights. But, equally, as we have already seen, there was also no longer any possibility of corruption being contained within market-tolerable bounds by central political authority. Confusion and uncertainty came quickly to prevail. In terms of the stylized Shleifer-Vishny models we were using to approximate a notional market for bribes, in this new era, the prevailing pattern in Indonesia now swung unambiguously to the competitive monopolies model. That is, individual ministers or agency heads, or regional government officials operating completely independently – all can be thought of as trying to maximize their own individual takes without any fear of sanctioning from above. The essence of this phenomenon is captured in the often heard complaint in Indonesia over the past few years that country now suffers from “hundred of little Suhartos”. From the point of view of investors who care (among other things) about a stable and conducive regulatory environment, this has been disastrous. The media is full of stories of firms not knowing whom (among the competing claimants) to pay, or paying multiple officials but still not getting secure property rights. Unsurprisingly, the net effect of this has been not just to slow down the return of investors to Indonesia (after the massive capital flight of 1997-98), but worse, investors who had remained in Indonesia have been leaving (BIES refs). Revealingly, this includes not just “footloose” industries such as textiles and footwear that are very sensitive to wage costs and can

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<sup>3</sup> Glaring examples abound. For cogent analysis of the problems of the Indonesian legal system, see Lindsey (XXXX) et al.

readily relocate to Vietnam or China, but the very much less mobile resource-extractive industries. When mining companies depart because of an impossible regulatory environment, it is indicative of something much deeper.

The enormous and historic political changes underway in Indonesia are to be celebrated. (I take this as given.) But note what it has meant for corruption. Here again, the reality challenges standard expectations.

### 3 Discussion

There is wide agreement among scholars and policy practitioners that corruption is a deep and corrosive problem. Similarly, there is wide agreement that, over time, entrenched democratic practices are the best way of curbing it. Neither of these fundamental propositions is disputed here. What this paper suggests, however, is that the dynamics of corruption in the universe of developing democracies and non-democracies is quite murky. Consider a notional continuum along which all political systems might be located, ranging from autocracies through developing democracies to entrenched democracies.

Autocracy	Transitional Democracy	Established Democracy
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Conventional wisdom holds that towards the left hand end of the range we are likely to encounter severe problems of corruption, towards the right hand end corruption is likely to be

moderate, and, other things equal, corruption to become progressively less problematic as we move from left to right. The primary implication of this paper is that reality is considerably more complicated.

Democratic governance and independent judiciaries do indeed offer the best prospects for combating corruption. But it would seem that, at least for a time, in the absence of these conditions other mechanisms can serve to prevent corruption stifling investment and growth. A centralized political framework giving leaders the ability and incentive to monitor and punish may be able to prevent corruption from completely poisoning the business environment. I have argued something like this operated in Indonesia – supplemented with the commitment mechanism of an open capital account – for roughly three decades. I strongly suspect that broadly similar arguments could be made for significant periods of the modern economic histories of Malaysia, South Korea and Taiwan. I do not claim that this powerful centralized autocracy model is the only alternative. It seems likely, for instance, that Thailand's more fluid political economy during the high growth era operated differently (Doner and Ramsay XXXX, Pasuk and Baker XXXX). And it seems that political economy of corruption in China also rests on a different dynamic, perhaps the mobility of capital between competing sub-national jurisdictions (Montinola, Qian & Weingast 1996), or perhaps these sub-national jurisdictions themselves having the essential features of powerful centralized autocracies (XXX in Campos). But this is a matter for further investigation.

Even before we get to comparative investigations, the arguments developed here raise important questions for both scholars and practitioners. To be clear, let me reiterate that I am not

questioning the general propositions about the deleterious consequences of corruption and the superiority of democratic governance and independent judiciaries. Moreover, not only were there other costs associated with the long rule of Suharto, the very corruption of the regime carried the seeds for its ultimate destruction. But the question implied by my argument is how hard we should be pushing for first best outcomes if [a] there are other mechanisms in place that, at least for now, seem to be working to keep corruption within market-tolerable bounds, and [b] the prospect for attaining not just competitive elections but also a credible legal system seem remote. China is the most obvious case in point.

The well-established challenge is to help struggling new democracies – such as Indonesia – build anti-corruption capabilities, especially in the legal sector. This paper points to a supplementary challenge: the need to understand the variety of other mechanisms for protecting property rights that may be available in authoritarian or weakly democratic settings, and to investigate whether these can be designed and deployed in ways that facilitate democratic transition.

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