# Self-Inflicted Wounds

Hilton Root

THE GLOBAL financial crisis that began with the collapse of the Thai baht in mid-1997 was fundamentally one of information mismanagement—that is, banks failed and markets collapsed mainly because crucial information was not collected and distributed to investors. Once burned, those same investors have understandably proved reluctant to return to markets where they mistrust the available financial data and, more generally, the credibility of host governments. To lure back investment, armies of financial specialists have been dispatched to Asia by the International Monetary Fund (IMF) and other multilateral institutions to establish basic standards of accounting and disclosure requirements for banks and firms.

But what these specialists have discovered is that the mismanagement they seek to remedy is often the product not of inefficiency but of direct and willful government action. More precisely, governments in Asia routinely misuse financial information for corrupt purposes or unreasonable taxation. Firms then respond by withholding this information, thereby reducing potential trade and investment. If a firm in China, for example, were to maintain the same standards of accounting as its counterparts in the United States, it would soon find itself subjected to a wide range of capricious interventions by state officials.

By contrast, the transformation of the U.S. economy made possible by the emergence of the public corporation in the late nineteenth century depended upon protection from arbitrary government. Without government financing, managers turned to the public and issued stock, the sale of which required the release of vital information. Because governmental opportunism did not jeopardize firms that accurately disclosed information, American businesses were able to create a thriving equity market. As firms grew by drawing capital from dispersed shareholders, enormous economies of scale developed. Municipalities learned that responsible public accounting permitted the financing of infrastructure by issuing bonds.

Private sector initiatives have not emerged, however, in present-day China, India, Russia and a host of smaller countries having their first serious encounter with a market system. This is not surprising: information about a firm's assets or ownership structure is simply not available in these places. Fearing confiscation of their assets, firms disguise their holdings as well as their management structure, which in turn constrains their ability to access capital effectively.

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Yet merely insisting upon improved accounting or auditing will accomplish very little in the developing world. The problem here is one of governance—specifically, malign governance. Legislation that forces banks to reveal their assets, liabilities and loan-loss provisions misses the source of these information failures. The obstacle to transparency in the financial sector is not a dearth of legislation but the developing world's political leadership. Financial mismanagement at the government level, which culminates in the plundering of banks and the restriction of access to alternative capital markets, has become a means of political survival in many states, one not easily surrendered to market forces the leadership cannot control. It is, of course, hardly news that many of the world's leaders stay in power by mismanaging their nations' resources. But until the practice ceases, the logic of international financial rescue will remain dubious.

IN JULY 1998, defending a $4.8 billion IMF loan to Russia that subsequently evaporated, then-Undersecretary of the Treasury Larry Summers reasoned that the United States took a calculated risk "because it was vastly better that Russia succeed than not succeed." The IMF loan was intended to foster financial sector reform. Instead, according to the IMF official that brokered the deal, the $4.8 billion was wasted on propping up Russia's currency long enough to "let the oligarchs get their money out of the country." IMF funds likewise provided Indonesia's Suharto sufficient breathing space to designate a successor while his children were overseas directing the family's money out of the country. As a result, the Suharto clan now possesses the resources to buy back at discount prices enough assets to dominate the Indonesian economy for years, perhaps even generations.

Indeed, it is in East Asia that we find this pattern at its worst. Twenty years ago leaders in that region were busily channeling resources toward national development and growth. As wealth and prosperity increased, however, supervision of the financial system as a public good declined. Instead, Asian leaders today routinely provide their friends and supporters with bank loans, public funds and access to subsidized credit, disregarding the economic risks of doing so. Hence, politicians concerned primarily with political power for its own sake have looked the other way as domestic banking credit has outpaced GDP growth, with predictably ruinous consequences.

The transformation of Korea's banking sector as that country became wealthy and democratic illustrates the point. Because political access lowered their cost of capital, Korea's large *chaebols* set about acquiring new assets, many of them unproductive. In the process, they disregarded profitability, subsidized loss-making business ventures, and promiscuously invested in unrelated sectors of the Korean economy, from steel and automobile manufacturing to real estate and hotels. Even the financial crisis that now threatens the country's prosperity has done little to disrupt this expansion. Quite the contrary: economic collapse has enabled the top five *chaebols* to seize control of a still larger portion of the devastated economy. Loss-making industries are simply dislodged on the public, while the *chaebols* consolidate the profit-making jewels.

Japan, too, features a banking system in which loans are divorced from market considerations. As in Korea, government policy in Japan, which encourages informal banking arrangements, has reduced the cost of capital for firms, allowing them to measure performance on the basis of market share rather than on rates of return on investment. For years,

Japanese officials have looked aside as firm managers created vast profits not reflected in corporate accounts. Many observers believe that the Japanese government rejects full disclosure of the banking system's assets and liabilities out of fear that political malfeasance will be exposed. And though international organizations promote the use of outside auditors to ensure that the business sector discloses its borrowings, the Japanese Finance Ministry has simultaneously promoted a means of circumventing this practice. It simply places a cap on how much a private firm can spend on an audit, a cap established at a level sufficiently low to thwart an effective job being done. If fraud is later exposed, it is the accounting firm, handicapped from the outset, that is usually blamed. Accounting firms, in turn, accept this risk as the price of gaining new business.

Japan is not the only country in which politicians encumber full disclosure of assets and liabilities. Political leaders across the globe have designed governmental bureaucracies with the express purpose of hiding financial information. Banks that cannot, or do not, perform basic accounting functions are often part of a larger structure of opaque regulations, politicized judiciaries and capricious tax systems. The resulting budgetary chaos distorts economic performance, to be sure, but such corruption keeps politicians in power.

The banking crisis the world confronts today recalls an observation once made by Schumpeter: "The public finances are one of the best starting points for an investigation of society, especially of its political life." One of the most basic tests of accountability that a country must pass is the ability to identify and collect taxes. It should come as no surprise, then, that the largest debtor countries in the world collect only a small fraction of the taxes owed them. Of the estimated 73 million Brazilians in the work force, only 7.6 million pay income taxes. Out of a Pakistani population of 140 million, an estimated 1 million pay income taxes. Mexico reports about 19 million registered taxpayers in a country of nearly 100 million people, and its finance secretary reports the country has the highest rate of tax evasion in the world. In the Philippines, of 12 million potential taxpayers only 2 million contribute. The situation in Russia is better; collections there account for as much as 50 percent of what taxpayers owe the treasury. Citizens in many of these countries so distrust the government that they hide their fortunes under mattresses or stash them overseas.

IRONICALLY, international financial assistance often exacerbates mismanagement by insulating failed regimes and allowing them to continue to reward supporters. Investors, of course, view loan-making institutions as a source of credible information. Indeed, the mere willingness of these institutions to extend credit establishes certain expectations about a nation's economic performance. Unfortunately, their loan approval processes rely on information gleaned from a compromised source—namely, the same political leaders who wrecked their nations' economies in the first place. Being accountable to their membership, international organizations thus become vehicles of misinformation and lack the independence to play the role expected of them as a neutral source of analysis and information. Under Suharto, for example, the representative of the Indonesian government at the World Bank was able to prevent the dissemination of research that questioned the wisdom of Indonesia's economic policies.

Then, too, international loan packages, which are often negotiated through

secret agreements with a single branch of government, actually weaken the main source of policy reform: the need for public accountability. When domestic financial crises broke out in England (1669), France (1789) and Japan (1868), no international donor existed to bail out political leaders. Bankrupt rulers were driven into the hands of their own citizens, who insisted on sound policies in exchange for the taxes they remitted. Indeed, international watchdogs can never substitute for accountability to citizens who pay taxes and thereby tie their fortunes to those of the state. Such organizations can at best empower local systems of accountability. However, when the deal is secret and conceals essential economic data, neither investors nor citizens can assess how a government is performing. And such agreements allow leaders, *ex post facto*, to claim a lack of public support and to renege on loan agreements once the funds have been dispensed. Recall how in early 1998 Suharto sought to use the riots that his policies induced in Indonesia as a pretext for evading the conditions of the deal he had signed with the IMF.

Contrary to prevailing wisdom, the serial fiscal failures of some of the world's best endowed nations are not the result of a mysterious contagion, nor of exploitation by developed countries or by the "international system." The blame lies closer to home. The afflicted nations—Brazil, Indonesia, Mexico, Pakistan and the Philippines, to name a few—have all become caught in binds of their own devising. And the financial architecture that has been engaged to surmount this global economic disaster has merely ended up compounding it. That architecture—which has allowed leaders to draw support from international organizations without engaging the will of the citizens who must pay these organizations back—has created a fundamental misalignment of economic incentives, the benefits of which have been largely private, while the debt has been public and sovereign. Fostering greater accountability where it is ultimately needed will require subjecting the leaders of sovereign states to the will of the peoples they govern. Only then can this global system of taxation without representation be reformed. □


Statement of Ownership, Management, and Circulation
(Required by 39 USC 3685)

1. Title of Publication: The National Interest. 2. Publication No. 0884-9382. 3. Date of Filing: October 1, 1999. 4. Frequency of issue: Quarterly. 5. No. of Issues Published Annually: 4. 6. Annual Subscription Price: $26. 7. Known Office of Publication: 1112 16th St., NW, Suite 540, Washington, DC 20036. 8. General Business Office of Publisher: 1112 16th St., NW, Suite 540, Washington, DC 20036. 9. Publisher: Irving Kristol. Editor: Owen Harries. Managing Editor: Michelle Brawer. Address: 1112 16th St. NW, Suite 540, Washington, DC 20036. 10. Owner: National Affairs Inc, 1112 16th St., NW, Suite 540, Washington, DC 20036 (nonprofit corporation). 11. Known Bondholders, Mortgagees, and Other Security Holders Owning or Holding 1 Percent or More of Total Amount of Bonds, Mortgages, or Other Securities: None. 12. The Purpose, Function, and Nonprofit Status of this Organization and the Exempt Status for Federal Income Tax Purposes Has Not Changed During the Preceding 12 Months. 13. Publication Title: The National Interest. 14. Issue Date for Circulation Data Below: Fall 1999. 15. Extent and Nature of Circulation: a. Total No. Copies: Average No. Copies Each Issue During Preceding 12 Months, 15,150. No. Copies of Single Issue Published Nearest to Filing Date, 21,111. b. Paid and/or Requested Circulation: 1. Paid/Requested Outside-County Mail Subscriptions Stated on Form 3541: Average No. Copies Each Issue During Preceding 12 Months, 3971. No. Copies of Single Issue Published Nearest to Filing Date, 3365. 2. Paid In-County Subscriptions: Average No. Copies Each Issue During Preceding 12 Months, 0. No. Copies of Single Issue Published Nearest to Filing Date, 0. 3. Sales Through Dealers and Carriers, Street Vendors, Counter Sales, and Other Non-USPS Paid Distribution: Average No. Copies Each Issue During Preceding 12 Months, 3046. No. Copies of Single Issue Published Nearest to Filing Date, 4581. 4. Other Classes Mailed Through the USPS: Average No. Copies Each Issue During Preceding 12 Months, 1365. No. Copies of Single Issue Published Nearest to Filing Date, 1577. c. Total Paid and/or Requested Circulation: Average No. Copies Each Issue During Preceding 12 Months, 8382. No. Copies of Single Issue Published Nearest to Filing Date, 9523. d. Free Distribution by Mail: 1. Outside-County as Stated on Form 3541: Average No. Copies Each Issue During Preceding 12 Months, 0. No. Copies of Single Issue Published Nearest to Filing Date, 0. 2. In-County as Stated on Form 3541: Average No. Copies Each Issue During Preceding 12 Months, 0. No. Copies of Single Issue Published Nearest to Filing Date, 0. 3. Other Classes Mailed Through the USPS: Average No. Copies Each Issue During Preceding 12 Months, 43. No. Copies of Single Issue Published Nearest to Filing Date, 37. e. Free Distribution Outside the Mail: Average No. Copies Each Issue During Preceding 12 Months, 4240. No. Copies of Single Issue Published Nearest to Filing Date, 8150. f. Total Free Distribution: Average No. Copies Each Issue During Preceding 12 Months, 4283. No. Copies of Single Issue Published Nearest to Filing Date, 8187. g. Total Distribution: Average No. Copies Each Issue During Preceding 12 Months, 12,665. No. Copies of Single Issue Published Nearest to Filing Date, 17,710. h. Copies Not Distributed: Average No. Copies Each Issue During Preceding 12 Months, 1312. No. Copies of Single Issue Published Nearest to Filing Date, 3264. i. Total: Average No. Copies Each Issue During Preceding 12 Months, 13,977. No. Copies of Single Issue Published Nearest to Filing Date, 20,974. Percent Paid and/or Requested Circulation: Average No. Copies Each Issue During Preceding 12 Months: 66%. No. Copies of Single Issue Published Nearest to Filing Date: 54%. 17. I certify that the statements made by me above are correct and complete. Michelle Brawer, Managing Editor.