

INSTITUTE VIEW



By **HILTON ROOT**

While feuding over how to respond to the global financial distress that began with the collapse of East Asia, multilateral lenders agreed on the need for rigorous accounting standards requiring banks to reveal their assets, liabilities and loan-loss provisions. But this entirely sensible prescription begs a critical question: Why have otherwise-competent governments in emerging economies not

produced well-regulated banking systems on their own?

One answer is that the interests of their leaders are often quite different from those of the public. In fact, financial mismanagement, culminating in the plundering of the banks and the suppression of alternative capital markets, is often part of a political survival strategy – one not easily surrendered to faceless liberal forces the government can't control. Unless reformers recognize this fundamental misalignment of interests and find ways to overcome it, reforms are bound to be frustrated.

It should hardly be news that many of the world's leaders maintain their grip on power by manipulating access to economic resources – capital, technology, infrastructure – insuring that key supporters are rewarded. Oddly, though, the resulting waste is often ignored by those who plead for international financial support for discredited regimes.

Defending the \$4.8 billion dollar International Monetary Fund loan to Russia that went sour last summer, Larry Summers, Under Secretary of the Treasury, reasoned that the United States took a calculated risk "because it was vastly better that Russia succeed than not succeed." The cash was intended to foster financial-sector reform. Instead, according to the I.M.F. official who brokered the deal, the \$4.8 billion was squandered, only propping up the currency long enough to "let the oligarchs get their money out of the country." What Summers apparently did not appreciate was that the interests of the rulers and the interests the country are not the same, and that institutions to make Russia's rulers accountable to the Russian people do not exist.

A quarter-century ago, leaders of East Asia's high performers, preoccupied with the question of national survival in an era of Communist expansionism, made sure that resources were invested in development and growth. However, the evolution of China from "threat" to "economic competitor" undermined the imperative to maximize the efficiency of investment. As wealth and prosperity increased, maintaining political power became an end in itself and supervision of national financial systems declined.

The evolution of the Korean economy illustrates the consequences. Politicization of the banking sector effectively guaranteed gigantic conglomerates, known as

chaebols, access to cheap capital. This allowed the chaebols to pursue market size as an end in itself, even as they poured money into loss-making business units. The resulting overcapacity has brought the Korean economy to the brink of disaster, though it has not derailed the conglomerates. In fact, the top five have actually toughened their grip, dumping worthless assets and consolidating the jewels as part of a much-heralded industrial rationalization plan.

Political favoritism in bank lending similarly allowed the friends and relatives of Indonesia's former President Suharto to loot the economy of one of the world's potentially richest nations. Now the entire banking system must be recapitalized. If Indonesia follows the path that Mexico took two decades ago, we can expect that, once the banks have been nationalized, they will be sold back to their original owners at scandalous discounts.

Japan, like Korea, features a financial system in which loan decisions are not disciplined by market forces. The cost of capital for Japanese companies has been artificially reduced by a combination of government policy and less-than-arms-length relationships with banks. Since the big companies financed development with borrowed funds rather than equity, they were able to measure performance by market share rather than profitability. Many observers believe that Tokyo has dragged its feet on full disclosure of the assets and liabilities of the banking system out of fear that political malfeasance would be exposed.

Ironically, while international organizations supported by Japan promote transparency as the universal medicine for misallocation of capital, Japan's own Ministry of Finance has found a way to circumvent good accounting practices. It caps the amount a private company can spend on outside audits. Then, if fraud is later exposed, the accountants, handicapped from the outset, can be blamed.

The crises in public finance of the world's most promising emerging markets are often rooted in their political culture and institutions. Throughout the world, badly regulated banking is often part and parcel of a failed system of governance. The obstacle to international growth once posed by central planning has been replaced by a subtler threat: deliberate mismanagement.

There is no better indicator of rule by mismanagement than the failure to identify and enforce tax liability. Is it any surprise that the great debtor countries in the world collect so small a percentage of the taxes they are owed? Of the estimated 73 million Brazilians in the work force, only 7.6 million pay income taxes. Out of a population of 140 million in Pakistan, just 1 million pay income taxes. Tax evasion among Mexico's 15.7 million black-market vendors cost the Treasury the equivalent of \$2.7 billion in 1997. The Philippines collects taxes from only 2 million of 12 million possible taxpayers.

These same debtor countries share another dubious distinction: Their citizens have stashed vast amounts overseas, often more than the total international debt owed by their governments. Meanwhile ordinary citizens hide their fortunes under mattresses, so that the banking system cannot effectively mobilize national capital reserves. An estimated \$60 billion is secreted this way in Russia.

The countries that lead the world economy today did not always pass the basic test of fiscal accountability. In the not-so-distant past, the distinction between public and private had little meaning in France, Britain or Japan. In time, though,

rulers desperate for revenue were driven into the hands of their own citizens, who insisted on oversight in exchange for their taxes. The separation of the leader's private interests from the interests of the state was thus driven by fiscal imperatives. The state became a separate power and the age-old identification of the ruler and the state, *l'état c'est moi*, was surmounted.

By contrast, the financial architecture used to solve today's global economic crises allows leaders to draw support from international organizations without engaging the will of the people who must ultimately pay back the loans. This form of taxation without representation is an anachronism that reinforces governance without accountability. It contributes to a fundamental misalignment of economic incentives: the benefits are largely private, the debt is public and sovereign.

International bailouts create a political variation on classic "moral hazard," encouraging leaders to take extreme risks with their nation's finances and later passing the costs along to citizens in the form of debt overhang. Inadvertently, international intervention contributes to the private economic fortunes that perpetuate political domination by the individuals who benefit most from their countries' ruin.

Is it any wonder, then, that the populist opposition in emerging markets typically sees the I.M.F. as an enemy? Any reform of the world's financial architecture is virtually certain to fail unless it establishes the rights of citizens as stakeholders in their nation's future.

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