Institutions for Healthy Assets Market and Economy: A Retrospect for Indonesia before 1997

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Abstract

The financial market is a subset of assets market. Its efficiency is very important for economic development, functioning as a screening institution for investments. The property sector is another group, comprising urban land. Urbanization is unavoidable, but very important for developing countries, including Indonesia. The process needs huge amount of investment, both private and public. There are many choices, and the financial market should be capable to channel the funds to the best overall investments. It should avoid any unproductive investment, including speculation. Banking is the most important of the financial institutions in Indonesia, which is later complemented by the capital market. As a dominant financial intermediation from the society, the commercial banks should channel the funds to the highest productive sector, reflected by its rate of returns, both the ROI and the ROE. As a rule of thumb, the two indicators should be higher than the deposit rates or lending rates. They should also be higher than the implied return for undeveloped urban land. If not, there is inefficiency. The study of the two indicators on a number of firms in the Jakarta Capital Market and the calculation of the "implied ROI" for urban land show that it is higher for the second. It leads to the conclusion of the inefficiency of funds allocations, and the banking system has failed to screen the best investments, while the capital market does not satisfy the EMH. Why? The answer lies in the absence of adequate institution in the assets market, namely the lack of investors and society's participation on financial supervision, wide availability of adequate information on comparative investment alternative, freedom from favoritism in the banking system, independent institution for the valuation of the assets market.

Key words: Assets, pricing; urban land market; capital allocation; distortion

JEL Classification:B52, G12, G14, O18, R51

Introduction

Even though the 1997/98 crisis has been closely 10 years passing, the analysis of the economic situation at that time is still attractive. In analogy with the 1930 depression, the publication on the issue, based on new information or new methods of analysis was till coming out. It will be useful for understanding the situation, hoping to improve policy formulation in the future. Likewise, this retrospect article is hoped to shed more lights on the occurrence of the crisis in 1997/98.

One of the prerequisites of the perfect market is the availability of information, which is equally accessible for all economic agents. The information should enable to set the price right for all assets in a competitive market. There should be an institution care for this task, searching for and disseminating the appropriate information. A competitive environment leads to an optimal allocation of resources, reflected in the equality of marginal-cost or -benefit for all activities. The received ideas assume that capital market is efficient, which means the validity of the EMH, or *efficient market hypothesis*. Unfortunately many studies have shown that the EMH is not wholly true[1]. The well-known *herd-behavior* in the capital market is a good example, indicating the irrationality of the market actors. The bubble phenomenon is found in the capital market, which will trigger a crisis when it bursts. Alas, bubble phenomena take place in the assets market in a larger context, as in the property market. It entails a cyclical boom and bust in the property market. The burst of the bubble is destabilizing. The excessive bubble is unstable, and it should be avoided. It needs to be supported by the right institutions to make it healthy. The critical point is the assessment of its true value and the right price. Crises hit the poor most severely and could trigger a social riots or upheavals. Hence crisis prevention has a pro-poor and stability dimension. So, it should be considered as a *public good*, not only domestically but also internationally. The right policy is to avoid excessive volatility and the irrationality of the assets prices.

By and large, the economy consists of three markets: products market, labor market, and capital market. At the margin, benefits should be equal to costs, and marginal costs between products within a market or between industries must be equal, and between the product and the capital. Financial market, as a subset of asset market in a general sense, serves all markets, because money or financial asset is fungible. Due to its fungible use, any flaw in the financial market leads to vaster distortion in the economy. As such, the financial market efficiency is crucial to the economic efficiency, because its distortions extend to subsequent activities in many sectors. Commercial bank is decisive for the developing countries. Hence the deposit rate in the banks is a reference point for the rate of return in the corporate sectors' investment. Such relation is critically important for the listed firms in the capital market, like in the JSX. Even though it does not imply as a necessary and sufficient condition for the performance of the economy due to the importance of the real sector, the efficiency of the financial and then the whole assets market is vital.

This article is an essay on the situation of assets market before the 1997 crisis, namely the property market and financial market. As such, the following discussion will be as follows: First, the introduction, giving the *raisons d'etre* of the article. Secondly, it will be followed by brief explanation of the assets market, namely the property and financial market. The property market will be dominated by the land price issues. Thirdly, the issue on the deregulation and liberalization of the economy will be treated, with a special note on the financial issue. Fourthly, the issue of urbanization and demographic development will be discussed. Urbanization process could trigger a hidden transfer of wealth within the society, from the general public to the land owner or developers. Following the fourth topic the process of getting rich by impoverishing other members of the society will be treated in the fifth part. The related issues on economic rents will be discussed here. The sixth part discusses the Indonesian Financial Market before 1997. The anomaly on the

[1] *A lot of works have been dedicated to this topics, see for example Shiller (1991)*

Indonesian capital market will be treated here, compared to the banking deposit rate and also the urban land prices development in several locations in Jakarta. Based on the obtained insights in the previous discussions, the seventh part treated the issue on the necessity of creating an appropriate institution to render the assets market healthy. There is a need for a private ordering, as was promulgated by the New Institution Economy, making the society care for resolving their disputes on land value and prices, especially in urban areas. Then part eight concludes, stressing the formation of a healthy economy, which is free from economic rents. Urban land economic rents is not just mostly damaging the poor people.

Dual Components of the Assets Market

As it is familiar to all of us, the financial system consists of three institutions, namely: the commercial banks, capital markets, and the insurance system. As it was said, the dominant financial institution in Indonesia is the commercial banks, much more than the capital market. Other non-banking financial institutions are still weak or in its incipient stage. The bonds market is also still weak, especially the government bonds (SUN) or the SBI (bank recapitalization bonds from Bank Indonesia). The bond market is important in the financial system, so it needs to be supported and developed properly. According to one of the IFC publication, an appropriate development of the bond market should be in place before the development of the capital market. It is the reverse which happened here.

Due to its development process, the pace of urbanization is high in Indonesia. One of the problems lies in the lacking of well-equipped land for all building purposes. Suitable land for housing buildings of all kinds requires infrastructures, necessitating huge amount of investments. While the financial capacity of the government is limited, the cities develop insufficiently equipped, leading to scarcity on suitable land for construction. It leads to urban land price hikes. Thirty years of continuous development with minor disturbances entails a feeling of *euphoria*, both for the government and the population in general. The price of urban land rises continually to irrational level without any questions. >From the other side, the urban development in Indonesia is more horizontally directed, because of the still unpopular high-rise housing for the population. Hence the high intensity of urban land for each housing unit, leads to scarcer situation of the urban land and higher prices.

For sustainable economic development, the economy should have a built-in system to direct the funds to the most productive investments, which are assumed, conducted by the market. But the markets should have been well equipped to do the job, and the experience in the assets market fail to conform to the conditions. In order to reach the result, there must be institution to do the job. The growth of monetary value of assets should be due to the real contribution of production, both now and/or in the future. The value of an asset should be equal to the present value of its future stream of incomes. This is important for a developing country like Indonesia with an important structural change in the economy, leading to significant change in the relative prices of products and assets.

The present value of incomes will be determined by the pattern of income and interest rates. Hence, by comparing the year-by-year return on investment to the deposit or lending rates, one will arrive at the conclusion, whether an investment is worth for the society or not. It is equally valid both for the price of a parcel of land or the stock price. They have to be equal to the present value of today's and future or implied incomes from the assets.

The markets, including the capital market cannot go alone. Other institutions should accompany it, namely a built-in-system for information provision. Inherently the asset market is

saddled with unsymmetrical or incomplete information, hence the demand for transparency. Following Khan et al [1999], the understanding of "institutions" comprises formal rules, informal constraints, and their enforcement characteristics. The enforcement of transparency requirement is a kind of institution. Any increase in the value of the assets should be justifiable, due to the rise in the implied or the potential incomes of the assets. The generally available information and the released one have to enable it. Without such a justification, the increase in the assets price could be economically false. Any increase in the asset prices, which are only the result of rising demand, without any prospect for *immediate* production contribution is unjustifiable. Other pertinent institution is the good practices on assets value assessment, and a system of voluntary enforcement of the right assets values by disseminating them to the public. It is not intended to replace the market, but a way to fill in the gap on the situation of unsymmetrical and incomplete information. In the product market, the flourishing advertorial activities show how lack the information is. So the point is the wide availability of the required information and the dissemination of the value assessment methods, enabling the public to determine or assess the asset price for themselves. It should be regarded as a public service provision.

Deregulation and Liberalization of the Economy

The first deregulation in financial sector in Indonesia was introduced in 1983, when the banks were let free to determine their deposit interest rates, not subject to the Central Bank ceiling, as the Regulation Q in the US (Kidwell, *et al*, 2000, p. 48). Further, the commercial banks were also free to allocate the credits according to the market mechanism. In the middle of 80s, fiscal reform was enacted, simplifying the tax brackets and the assessment procedures of taxable incomes, and then the introduction of the value added tax (VAT). The new step of the government policy was due to the declining incomes of the government from petrol since 1983 and other exported products. Sharp decline in the oil price in 1986, urged the government to shift to a new strategy: from previously government dominated economy to a private dominated system. There was a lot of liberalization, both in the financial sector and the real sector, namely on trade and industry. In 1987, the capital market was also liberalized. Fortunately, these resulted in a substantial revival of the whole economy, where the non-oil products and gas export surged. In order to abolish the bureaucratic handicaps for export, the custom operation was contracted to SGS (Société Générale de Surveillance), a Switzerland based private firm. In 1988, the government announced a vast deregulation package, a sweeping financial market reforms, especially for the banks. The package was familiarly dubbed as PAKTO 88. After the package, the establishments of new banks or its branches within the country were liberalized. The reserve ratio was substantially reduced, from the previous level of 15 percent to only around 2 percent.

The financial deregulation of 1988 proved to be decisive steps to jump-start the sector. It has been positive for some sectors of the economy, previously having bottlenecks in its development due to lacking in financial sources. But alas, there were several activities, where the demands were artificially engineered. The financial deregulation has made it possible for the banks to extend credit without sufficient reserves according to prudential attitude. The banking sectors were aggressive in supplying credit to the households. The global trend was in favor of the process, triggering a feeling of euphoria, neglecting the previous prudential or conservative well-accepted practices in the businesses and the economy as a whole. There was a wide laxity, both in the government circle and in the private sector. The meaning of deregulation has been misinterpreted, as if it is a system without regulation. The appropriate regulation in the financial markets, which is saddled with externalities, was vastly neglected. Any mention on regulation was considered as *passé*, and the deregulation *cum* de-bureaucratization was supposed all the necessary and sufficient

condition to unleash the potential of the economy. The *euphoria* attitudes make the people blind on the difference between the rise in the financial value and the value of goods and services. Any rise in the monetary value was considered as a positive.

One of the most spectacular negative impacts of the bank deregulation of 1988 was the entry of the actors in the sector, having no sufficient professional expertise, both the owners and the managers. The *fit and proper test* was totally absent. Many of the owners had the background of traders or industrialists. Many new banks and branches were established, and the human resources for that were scarce, leading to staff hijacking or employing inappropriate personnel to occupy all the available posts. The attitudes of the personnel did not stand up to what is required by the professions, especially in assessing the risks of the credits, but also in managing liability side. High potential return was automatically considered as profitable, without taking into account the attending risks. The thesis of the portfolio theory states that the higher the returns, the higher the risk of any investment. This was lacking in the spirit of those involved in the financial sectors of that time, an unprecedented vast deregulation.

The waves of deregulation are really meant to unleash the efficiency of the economy. Efficiency entails decline in prices, the rise in goods quality with the same price or both. In the banking sector, the price is equivalent to the interest rates. But what happened was the reverse: the level of interest rates was generally rising after the deregulation. Credit became abundant, but interest rates rose. There must be an error some-where in the economy. The economic actors were keen to find the potentially high return projects. Trading and property sectors were the darling of the market, which potentially rendering high returns. Some of the credits intended for industrial sectors were redirected to the real estate businesses in general or to the commercial buildings. Hence the oversupply of the property sectors, which later proven contributing substantial amount to non-performing loans. Vast financial deregulation leading to easy money was the culprit.

After the Bank Deregulation of 88, the capital market of Jakarta developed very well. Many companies were listed, resulting in the *disintermediation process* for the banking system. The best corporations were rushing into the capital market. The whole process has been squeezing the bank from two sides: from the asset side and from liability side. The '*highest quality'* corporate customers quitted the banks, which were used to be their fund provider, resulting in a loss of the best borrowers, drying up the cash flows for the banks[2]. The attractiveness of the capital market enticed a group of vital depositors to withdraw their funds from the banks and put them in other investment vehicle. In order to maintain the old depositors and to attract the new ones, the banks raised the deposit rates from the previous normal rate. The banks compete to attract the depositors, either by raising deposit rates and/or by offering prizes through lot drawing. It was felt necessary at a time when many best corporate customers bypass them by direct transaction with the final investors. The disintermediation process is well known and well recorded in the developed country, but was alien at that time to Indonesia. In the United States, the *Fortune 1000 corporations* utilized the money market rather than the commercial banks for their short-term borrowing because commercial paper rates were considerably lower [Gart, 1994, p. 3]. It became popular in Indonesia after the Bank Deregulation of 88.

Unfortunately the financial system fails to reveal the information on the economic realities in the grassroots, which confronts a series of challenges to the production system to succeed. There is no a *one-to-one* mapping between the decisive factors in the real economy to the information delivered by the financial reports. The vital information in the capital market inside the buildings is very different to the real situation in the field. There is huge gap between the realities with what is represented by the information. And it seems that without prior right institution in place to care for

[2] *The 'highest quality' should put in quotation marks due to the later facts, where most of those listed firms were in fact not as good as they were assumed (See later section on capital market performance)*

the right information, the deregulation pushed the negative trend to the worse situation. The mass media is still lacking in capabilities to digest and report the situation. Information pertaining to the capital and assets market in general should be considered as *public goods*, because it will touch the public, with important impacts for the economy.

Urbanization and
Demographic Development

The rate of population growth in Indonesia is still high compared to the industrialized countries, notwithstanding the success of the birth control program in the country. It has been successful in lowering the birth rate from more than 2 percent at the beginning of Suharto era to much less than 2 percent later. As a matter of fact, the rising role of the industries and services in the economy is accompanied by a rapid urbanization, much higher than the population growth. In the 80s, urban population growth is in the order of 5 percent. The rapid urbanization entails substantial rise of the demand for housing. In addition to that, there is a rising demand for land for industry and office building or other activities. All these lead to an urban land scarcity, provoking substantial rise on the urban land price. This is the demand side. Land for construction needs appropriate provision on infrastructures, namely road network, drainage system and ditches, and other public utilities like water pipe-lines, electricity, telephone lines, and so on. The required funds for public goods and public utilities provision is huge, which is much higher compared to the financial capacity of the country. As a result, the pace of public goods and public utilities provision falls short of demand. This is the supply side of the problem. This is another additional factor in raising the urban land price, on top of the rising demand due to rising population and activities. Rising demand for *cum* insufficiency of supply on the suitable urban land for construction leads to significant urban land price hike.

The rising price of urban land entails a rise in the prices of housing. But what is seen as more disturbing, both socially and economically, it entails a rising proportion of urban land cost in the price of houses. The pace of urban land price hike is faster than the rate of economic growth and/or inflation. The rising price of houses makes a barrier to entry for many households to the good housing. In the appendix, table AP4 presents a group of housing styles, showing the ratio of land price to the price of the house. The data is taken from a flier of a real estate firm. The ratio of land to house price in the table ranges from 54,3 percent to 69,1 percent. The ratio is very high compared to what is found in French and the U.S., which lies at around 20 percent. The ever rising price of houses, has a direct impact for the households, extracting more and more income for shelter. But the pace of wage rise falls short of the house price growth. The developers, seeking for cheaper land, build housing complexes in the city outskirts, becoming farther and farther from the city center or other activity center in the city. The population of the city in Indonesia is not used to live in the apartments of the multistory buildings. The city develops more in the horizontal dimension, instead of vertically, which has been the norm in the developed countries, namely in Europe and Japan. The still dominant preference of the population to live in individual house raises the demand for urban land, higher than if it were accepted to live in condominium or apartment building. This is also in conjunction to the culture of individual owner-occupier type of dwelling, so that the housing in the form of apartments is not popular. It needs more efforts to socialize the apartment housing styles.

By observing the public goods and public utilities in the urban area, one arrives at the conclusion that they are from the network type. Road network plays an important role as the reference framework of the city. Any network systems is endowed with the natural monopoly characteristic, subjects to economies of scale. Urban area is characterized by high density of public goods and utilities. All these networks constitute the underlying structure of the city, producing

substantial externalities in the city. The whole positive external effects consist of several contributions from many urban phenomena, network-system of public goods, embedded in the public goods characteristic, the economies of agglomeration. It is a mutually reinforcing process of the externality economy in the city.

In the macroeconomic account, household expenditures for buying houses or for its construction are classified as investment. House price inflation, due to the rising urban land prices, will drive the required investment up. The rise in the urban land price will also drive up the land price component for commercial building and trading firms. The same thing happens on the land for industries in the industrial estate complexes, raising the new investments for industries. In the aggregate, it is counterproductive to the whole economy, because it drives up the ICOR, leading to a reduction of the economic growth from a certain amount of investment funds. There are instances where the housing sector could be used as a stimulus for moving the economy out of depression, where capacity is underutilized and unemployment is rampant. But it is false to generalize it to all cases as in the following citation: <What is disputed is the view that the home ownership market now holds the key to economic recovery, and that all that is required to jump start the economy is a new housing demand and sales.[3]> If the economy has been at near or full employment stage, provoking a boom in the housing market could raise the land price, including the land for industries. It leads to the rise in the required initial investment for industries. Even though investments comprise expenditures for housing construction, the policy makers should pay attention to the whole capacity utilization of the economy.

Abolishing Hidden Transfer

It is clear that the unjustified increase of the urban land price has a negative impact to the economy as a whole. From the other side, it has an unfairness dimension: urban land price is highly influenced by the availability of public infrastructures and public utilities, external economy effects. The financial sources for the public goods are usually from taxes. From the other side, the unusually high price of urban land has its origin in the scarcity, not due to any growth in individual productivity. Hence the capital gain in the urban land has its origin in the scarcity factor *cum* the external economy impacts of the public goods or infrastructures. There is an unfair *hidden transfer* from the general public taxpayers to the landowners or the land speculators or the developers. The income of beneficiary from the "capital gains" in urban land is not earned in the sense that it is not the result of productive works. It is pure economic rent, is an unjust hidden transfer. Its negative impact in the form of rising ICOR is further complicated by unjust distribution of incomes. And on top of that, it will put the lower class of urban population in a more and more difficult situation to live in a decent dwelling. It has a deteriorating impact for the urban society, which in turn may trigger a *social upheaval*, leading to riots. In order to have a just & healthy economy there should be a right institution in place, endowed with the capacity and methods to do an appropriate assessment of true value and prices of the assets. The taxation system should be charged to extract most of the pure rents, used for financing the infrastructures and public goods.

The economy in question should be without unfair/hidden transfer of income, without appreciable rents[4], impoverishing one segment of the population. It occurs by legally forcing them to pay taxes used for constructing the public infrastructures. Houses should be primarily for shelter, not as a means of speculation. Getting rich from windfall gain in urban land due to scarcity is destructive because it is not a result of an act of production. It could provoke a wider speculation in urban land. It is a kind of the *casino capitalism*[5], which should be avoided, both for the reasons of

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[3] *Chis Hamnett: "Restructuring Housing Finance and the Housing Market", in Corbridge, S. et.al [1994]*
[4] *Rents become the material of discussion on incentive theory, see Laffont, J.-J. and Tirole, J. [1993]*
[5] *Susan Strange: "From Bretton Woods to the Casino Economy", in Corbridge, S., Ron Martin, and Nigel Thrift (editors) [1994], pp. 49-62.*

justice and economic efficiency. Any income has to be the compensation of work, either through wages by working for others or by enterprising. The thesis of J.B. Say proclaims that the capacity of someone to buy any goods should be the reflection of his capacity to produce other goods.

It is opportune to see the economy as a *pool of product values*: if someone takes a product and put the same value of product to it in exchange, the economy is in balance. But if a person takes a product without exchanging the same value of goods, the economy will be in imbalance. In the case of an imbalance, it results in the higher value of demand than the value of supply. It is contrary to prerequisites of JB.Say, provoking inflation. The act of taking product from the pool is the result of using the incomes from windfall gains to buy goods. Due to pure rents within the inflated price of land, the aggregate impacts in the economy will end up with what is characterized by Greenspan as follows. It is said: <… if you measure America's GDP by adding up output across the economy you get smaller figures than if you measure it by adding up incomes (in principle, of course, the two should tally) [6]>. But the incomes are the *unearned incomes*, meaning the incomes without *productive works*. The so-called *wealth effect* is now very popular in the United States of America, especially related to capital market. Alas, the latest report from the US showed a growing social inequality, even though it is not only to be ascribed to the *wealth-effects* phenomena. In the case of Indonesia, especially in the Jakarta area, the accompanying deterioration of distribution of income (inequality) is easily seen in the growing slump area, some of them are the previously expropriated landowners. The sense of unfairness in the society materialized in the recent *social upheaval*. The policy makers should task itself to avoid such an adverse situation, which should be the result of good economic and social policy, in the framework of the appropriate institutions. Getting the institutions right is the order of the day, where the good governance ought to be resulting from such framework.

Getting Rich By Impoverishing Others. Urban Case

Indonesia is still at its infancy stage in the process of industrialization. It is clear that it is accompanied by or provoking rapid urbanization. The pace of urbanization is much higher compared to what hitherto happened in the present developed countries. Due to the rapidity of urbanization, a much higher amount of funds for infrastructure provisions is needed, while the financial capacity is limited. From the other side, it is found that the capital gain for the beneficiary is substantially high. The following Table 1 below shows the prices of land in an area with low level of infrastructure availability compared to a high level one. This will be transformed into capital gains in Table 2 for the beneficiaries, entailed by an upgrading of the infrastructure from low to higher level.

Rent Nationalization Rather than Land Nationalization

Table 2 shows the magnitude of capital gain per km of road. At the time of the report, the construction cost per km of road (without the price of land) lied between 1000 to 2000 million rupiah. In the second circle from the CBD, by assuming the ZOI (zone of influence) of the road to be 100 M for each side of the road, the capital gain was at the order of 6-12 times the road cost. The capital gain is really huge, but unfortunately it is economically flawed because it does not add the same value of goods to the national *pool of goods*. It increases the income of the beneficiaries, enjoying *the wealth effects*, raising their purchasing power. The latest study confirmed that a rise in the wealth causes rise in demand.

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[6] *The Economist, June 17th 2000, under the "Economic Focus", p. 94*

Due to a (*temporarily*) *constant* supply of the goods and services, two things could happen: imports will surge, or prices will go up or inflation will happen, or the two could simultaneously happen. The rise in imports will deteriorate the current account, and the rise in inflation will disturb the economic stability and the exchange rates, which has negative impacts for international trade. In short, there will be economic disturbances to the economy due to windfall gains. There will be a deterioration of the distribution of income and wealth, too.

Table 1
Price of urban land per M2
with different infrastructure availability, Jakarta

Distance from CBD in km	Level of infrastructure availability		Percentage difference between high-low
	High	Low	
0 – 5.0	Rp 428,457.00	Rp 329,407.00	30.1
5.1 – 10.0	184,898.00	123,471.00	49.8
10.1 – 15.0	87,213.00	47,691.00	82.9
> 15.0	43,035.00	22,913.00	87.9
Overall	169,275.00	113,721.00	48,9

Source: Dowel et. al

Table 2
Calculated Capital Gain Per Kilometer of Road After Upgrading

Distance from CBD	Z.O.I., 200M to the right and left of the road (Rp. million)	Z.O.I., 100M to the right and left of the road (Rp. million)	Comment
0.0-5.0 Km	39,620.00	19,810.00	The construction cost of urban-road was approximately between 1000-2000 million rupiah.
5.1-10.0 Km	24,570.80	12,280.90	
10.1-15.0 Km	15,808.80	7,904.40	
> 15.0 Km	8,449.20	4,224.60	
Overall	22,221.60	11,110.80	
Z.O.I. = Zone of Influence of the road.			

Source: Calculated, based onTtable 1

The occurrence of this phenomenon does raise concern both on economic or social reasons, because it is not the result of productive works. Work has been one of the social institutions, for creating wealth. There will be social discord if anyone could amass wealth without supported by commensurate works. By considering the potential perverse social effects, it is a sound reason to

put appropriate instruments in place to avoid the pure rents to occur. This is the idea of the abolition of pure rents[7].

The capital gain is substantially higher compared to the construction cost of the road. At the time of the study, the land tax was still very low. For the reasons of justice, there should be a mechanism to charge the cost of the road construction to the beneficiary, not to be charged to the taxpayers. Bahl et al.[8] express concern on the way to capture the windfall gains: <The central question we raise is how better to finance the public services in large, growing cities and in particular how to capture the benefits of urbanization in order to increase the supply of services …>. But here the ultimate goal is for the purpose of making the economy healthy. To reach the objective, the capital gain of the urban land should be *nationalized*[9], meaning taxed away, so that the any incomes should have products as counterpart in the economy. The tax rate should be in a progressive system. If not, wide expectation on windfall gain will provoke wide speculation on urban land. *The nationalization of the urban land rents* is an institution for keeping firstly the urban land market healthy, then the economy as a whole, where every income should be the result of productive activities. A well accepted solid methodology for assessing the real value of urban land, both seen from an *individual owner perspective* and also from *the whole city perspective* should be implanted to the good practices business conduct, hence as another institution. The presence of externality phenomena in the urbanized area is the source of the difference between the two values. The availability of value assessment methodology for urban land should be the basis of the imposition of capital gains taxes for urban land.

Due to the present low level of urbanization in Indonesia, the process will continue with a substantial rate of growth. Urban spatial development, both in the form of urban extension or new urban formation, will entail a large new urban area built-up with its inherent economic rents problems. Continuing urbanization and the population growth will work in tandem to increase the degree of scarcity of urban land for housing and other activities, leading to price hike as previously mentioned. It is complicated by the limited financial capacity of the government for the provision of urban infrastructure. The whole situation does not sit in harmony with the windfall gains to beneficiaries, landowners or speculators of developers, both from the justice and economic efficiency reasons.

[7] *Incentive theory as described by Laffont, J.-J, and Jean Tirole [1993], has a final objective for abolishing rents. The examples from the MIT Energy Laboratory [1984] and FERC [1989] lead to the argument, that the acceptable rates of return is in the range of 13% < r < 15%. If more, it contains rents. See p. 16.*

[8] *Bahl, Roy W., Johannes F. Lir [1992], p. 1*

[9] *The source of idea on the urban land rents nationalization is the idea of Leon Walras on nationalization of land, due to the potential unlimited price hike. Walras propose the nationalization of land in order to preserve the market system in the economy as a whole. Here, the author propose the above substitute.*

The timely provision of such institution will lead to better fund allocation, between real production activities and speculation on land or in other general assets. Land is not a commodity because it is not produced. Land is inseparable from the house or group of houses or other buildings. Due to those reasons the price of land in the whole house price and other buildings should get only a just proportion. Urban land or land speculation in general, based on the rising scarcity and its manipulation to raise its price unjustifiably high should be avoided. As it was previously said, the main purpose of house ownership should be for shelter, not for speculation. It could be deterred by imposing progressive taxes on the second, third and further houses. There should be an endogenous incentive system in the economy to raise the preference of the earned incomes from productive work or activities rather than from pure economic rents.

In practice, there is a policy-entailed distortion in the urban or general land market in Indonesia. The land used for public infrastructures is priced far below the market, with an argument that the infrastructures are for public uses. The owners of the land feel an unjust treatment. There is hidden dissatisfaction among those whose lands were expropriated for roads, schools, buildings and property for defense purposes, and so on, because they did not get the just compensation according to prevailing land price formation. But economic theory tells us that the price of any goods should be the same, no matter for what purpose. The aggregate benefits of using a public infrastructure should be more than an individual benefit, under the condition that the assessment is correctly conducted. If it is not, then the public good concerned is not worth to be constructed. It is necessary to stress here, that the government should be the first to apply the economic efficiency principle, due to its position as a *superstructure* institution. The equality of land price for public and private use at the adjacent sites should be equal. In a country like Indonesia, the practices in the state level will be considered as a good example to follow. So the government has to task itself to set the prices of all resources right, especially on resources used for public goods, namely land in the urban areas.

The negative social side of the process of *enrichment without cause* is the rising price of houses in the urban area, where the price of land is dominant, reaching 70 percent of the price of the house. More and more households become marginalized, living in the houses without sufficient sanitation. At the time, the government introduced house plans, with the floor area of 36 square meter, and then reduced to 21 M2, irrespective of the family size. Some of these households were from the expropriated land for infrastructure, or generally from incoming migration from the rural areas. It is a contrast situation: the purpose of all developments is proclaimed for the general welfare. But in fact, some of the population become poorer while others are better off, enjoying a better living but without productive activities counterpart. The process of such *impoverishing development* should be avoided, where the urbanized area lies at the forefront. It happened in the mid of rampant speculation on urban land, raising its price to the advantage of a few. Here the usual perception that speculation will equalize the price in several markets could not be valid. One of the disturbing facts is that, that some speculators are not the owners of the land, leaving some owners on the losers' side. The data in table 3 below shows the development of urban land price in several locations in Jakarta. The table shows absolute land price development in million rupiah per square meter, and followed by the yearly percentage price growth, and then the whole period growth rates (geometrical growth rates).

In the same table, it is also presented the year-by-year inflation and the period average inflation rate, followed by yearly deposit rates, completed by the period deposit average rates. It is easily seen that the urban land price growth rates in the six locations are higher than either the inflation or the deposit rates. What does it mean? The benefit of *investing* in land is much more beneficial than placing the money in the banks. In real terms the monetary values of the urban land in the six locations grow with very high rates, having a net impact of increasing the wealth asset in monetary terms. From this point of view, investment in the urban land guarantees a high return,

compared to other acts of investing in industrial activities, as it will be clear in the following discussions. But unfortunately, risk consideration is absent, leading to incomplete contract situation in the incentive theory. The actors are only thinking on profits without considering any potential bust.

Rent-free Economy as a condition for Healthy Economy

In the one of the footnotes of this article on the issue of pure economic rent, which is referred to the books of Messrs. Laffont and Tirole, the supposed to be acceptable rates of return in the New York Telephone Co. was between 13-15 percent. The cited corporation is a productive activity, rendering services to people. The rates of return in the telephone company is surely the result of earning income by putting services to the national pool of goods, an exchange with equal footing. This is a sound prerequisite of a healthy economy, *an exchange of production in goods and/or services*. Monetary income should only be a reflection of the real exchange of produced goods and/or services in the economy. The exchange process should not bring about an excessive rate of return, even though it happens in the real production of goods and services. Any excess in rate of return contains a pure economic rent component. This is one of the main messages of the modern incentive theory: *pure rent abolition*. In order to be able to maintain or to construct a healthy economy, it is worth to firstly well identify the potential sources of pure economic rents. Both from the long time experiences of the developed countries and the still short experiences of the developing countries, the conclusion is clear, that the urban land is potentially containing pure economic rents. Hence, the attention of the development economic should be also directed to this field. Urbanization with its urban land price problems alongside with its potential *impoverishing impacts* should be avoided or minimized to the extent possible.

The following table, table 3, shows the urban land price development and the yearly growth rates in six (6) locations of Jakarta. By reiterating the previous arguments, the rise in the urban land price in the six locations is surely contaminated by the pure economic rents case. By comparing the land price development to the deposit rates, it is easily seen that placing money in urban lands is more profitable compared to bank deposits, or even by investing the equity market. This is a distortion in the economy.

Table 3
Urban Land Price Development in Several Locations of Jakarta, Inflation, & Deposit Rates Land Price in Rp. Million/M2

Location	Year														
	1983	**1984**	**1985**	**1986**	**1987**	**1988**	**1989**	**1990**	**991**	**1992**	**1993**	**1994**	**1995**	**1996**	**96/83**
Rasuna Sd	0.4	0.4	0.45	0.45	0.6	0.7	1.2	2.8	3.2	4	4	4.6	5	5.6	14
Gtt Subroto	0.6	0.6	0.65	0.75	0.9	1.25	2	3.4	3.65	3.8	4.6	5	6.5	8.2	13.67
Sudirman	0.7	0.85	0.95	1	1.25	1.8	3	5.5	6.5	6.5	7	7.5	8.5	10	14.3
Pdk Indah	0.16	0.18	0.2	0.275	0.35	0.45	0.7	0.9	1.1	1.25	1.4	1.75	2.1	2.5	15.6
Kbn Jeruk	0.1	0.125	0.15	0.175	0.25	0.425	0.5	0.55	0.6	0.7	0.8	1	1.1	1.2	12
Bintaro	0.06	0.08	0.11	0.125	0.14	0.16	0.18	0.25	0.35	0.4	0.45	0.55	0.7	0.75	12.5
Yearly land price growth, %															
	1983	**1984**	**1985**	**1986**	**1987**	**1988**	**1989**	**1990**	**1991**	**1992**	**1993**	**1994**	**1995**	**1996**	***Avrg.****
Rasuna Sd		0	12.5	0	33.3	16.67	71.4	133	14.3	25	0	15	8.7	12	*22.5*
Gtt Subroto		0	8.33	15.38	20	38.89	60	70	7.35	4.11	21.1	8.7	30	26.2	*22.3*
Sudirman		21.43	11.8	5.263	25	44	66.7	83.3	18.2	0	7.69	7.14	13.3	17.6	*22.7*
Pdk Indah		12.5	11.1	37.5	27.3	28.57	55.6	28.6	22.2	13.6	12	25	20	19	*23.6*
Kbn Jeruk		25	20	16.67	42.9	70	17.6	10	9.09	16.7	14.3	25	10	9.09	*21.1*
Bintaro		33.33	37.5	13.64	12	14.29	12.5	38.9	40	14.3	12.5	22.2	27.3	7.14	*21.4*
*** Geometrical average growth rates between 1983 until 1996.**															
Inflation, %		10.4	4.8	5.7	9.3	8.1	6.4	7.8	9.4	7.6	9.6	8.5	9.4	8	*7.9*
Deposit Rt.	6	16	18	15.4	16.8	17.7	18.6	17.3	23.3	19.6	14.6	12.5	16.7	17.3	*15.8*
Inflation average rate: 1983-96 = 7.9 %							Deposit average rate: 1983-96 = 15.8 %								

Source: Summarized and calculated from several tables, Simarmata

The rise in an asset price due to the increase in its future productive capacity is surely justifiable. The construction of an infrastructure in a city will increase the production capacity of the city system and the enjoyment of cheaper services. These are real benefits, partly generated by the infrastructure provision, financed by taxes. The whole benefits of city development, resides in the framework of *positive sum games* should be for the whole urban community, not to limited number of landowners. The aggregation process of people is the precursor of the city benefits, which go hand in hand with the natural endowment of the area. The combination of the two, complemented by much human enabling quality to take advantage from the advancement of science and technology will play a great role in the productive capacity formation of the city. If within and due to the process any factor of production or any asset experiences a price hike, substantial part of the monetary benefits due to the rise should go to the society. If not, the asset holders have obtained undue income. The example of Laffont and Tirole in the telephone service leads to a lesson, that the profits of the developers in the property sectors should be comparable to other production activities. The beneficial site of the urban land for property is due to the presence of many infrastructure networks, having a natural monopoly characteristic, in analogy with the telephone network. The example in Indonesia violates that similarity, as the level of profit for developers is much higher than in other industries.

Surprisingly, urban house market shows inconsistency with the house rental market. From several case studies in Jakarta, it was found that the present value of the house rentals for the technical life of the structure was much lower than the cost of the house, namely the cost of land plus the construction cost of the building. Even worse, the present value was less than the price of

the parcel of land for the house. The calculations were conducted for several levels of interest rates: the then prevailing rates, 15 percent, and 10 percent. Besides that, the house rental has in addition been assumed to grow 10 percent per year. Even by using 10 percent interest rates plus an yearly rental growth of 10 percent, the present value of the house rental was still less than the land cost of the house. It should be stressed here that the calculation has been neglecting the risk factor. If the risk factor has been taken into account, it should raise the interest rate several percent higher than the going or market interest rates. This is the controversial fact, even without taking the risk factor, the house renting does not render a suitable rate of return. Such situation should incite the capital owners to shift their investment to other activities. But what happens is the contrary. The fact seems to confirm the hypothesis that the house-owners do not expect yearly income from their investment but waiting only for capital gains in the future[10]? There is no systematic link between the rental price of the house with the house market price. The expected relation should be analog to the relation between the bond price with its coupon rate. Otherwise stated, the rental price divided by the house price should be equal to the level of interest rates. The data on rental and the price of the house seem to contradict the assumption of EMH since there is no relation between housing rental prices with the house price. Are they aware of the speculative nature of their '*investment*'? It is not a genuine investment, and so, it seems necessary to "go back to basic" on the meaning of investment. The recent very high prices of houses in the industrialized countries[11] shed lights on the impropriety of those assets to the normal practice of investment outside the housing markets.

Indonesian Financial Market Performance

It was mentioned above that the banking deregulation is enacted within the framework of the 1988 financial deregulation. Since 1989, after the banking deregulation, the capital market was on the rise, until before the 1997 crisis. A lot of comments have been directed to the capital market performance, where some were concerned with the *casino-like* situation of the capital market. Some are concerned with the fact that the rise in the stock price was not justified by the rise in the corporate profits[12], or worse the corporation incurs a loss. How could such a situation come about if the so-called EMH does hold? This is one of the signs of the capital market inefficiency, lack of corporate governance.

As it was written above, the pillars of the financial system are the banking system, the capital market, and the insurance and pension funds. The highest nominal outstanding credit in the banking system in June 1998 was 626.5 trillion rupiah, and at the end of 1999 it was only 225 trillion rupiah. There was a substantial decline in the nominal outstanding credit. This is mostly due to the very bad situation of the banking system, saddled with a huge amount of *non-performing loans*, NPL and the real sectors are mostly stuck in the red. From the other side, the index of the JSX is hovering around 500, rebounding from its lowest level at around 250, rising to the level of approaching 600, and then falls to the level of 500. Market capitalization of JSX at the end of 1998 is 175.7 trillion rupiah, or 22.1 billion US$ equivalent. There are two capital market centers, namely in Jakarta and Surabaya. Unfortunately, the bond market is still underdeveloped. And the mortgage market is almost negligible. This is regrettable, because the bond markets as important source of long-term debt is missing. The lack of mortgage market is also regrettable due to its contribution to the right assessment of the property price is positive. The insurance and pension plan system is still at its beginning stage. Life insurance system consists of life insurance companies, non-life insurance & reinsurance companies, social insurance, and civil servant &

[10] *Bahl et Flir states <... to the extent that the after-tax rate of return on investment in housing is reduced ... capital owners may reduce maintenance of and new investment in housing and shift their resources to other uses, ...>. This is the logic of the received ideas on investment, which is violated in property in Indonesia.*

[11] *See the BIS report on these issues: CGFS No. 26, p. 8*

[12] *The writer expressed the critic on this in one of its "in-house" seminar on rents (someday in 1994/95).*

army insurance. At the end of 1997, total asset of life insurance is 12.345 trillion rupiah, non-life insurance has a total asset of 8.187 trillion rupiah, social insurance is of 6.454 trillion rupiah, and the insurance of civil servant & the army is of 5.023 trillion rupiah. The grand total of the assets of the insurance system is 32.009 trillion rupiah. The role of the insurance company to the property value assessment is limited to the insurable part of the building, excluding the land. It is clear that the mortgage market is very important. Compared to two other pillars of the Indonesian financial system the total asset of the insurance system is still low. The comparison of the whole bank outstanding credit, capitalization of the capital market, and the insurance system does confirm the preponderance of the banking system.

The commercial banking in Indonesia is surely the most vital one within the financial system, followed by the capital market. Due to their dominant role, the performances of the two systems could be considered as important indicators of the performance of the financial system. From the capital market, the Return on Equity (ROE) and the Return on Investment (ROI) are used as the success indicator of the capital employment, while the deposit rate is considered as an indicator of the healthiness of the banks system. The bank real interest rate should be comparable to other countries. This very important at the time of free flow of investments, because the funds for FDI are taken from foreign investors, usually with lower interest rates than the domestic rates. The difference in rates could put local firms in a disadvantage position, indicating the inappropriateness of the domestic interest rates. In evaluating the performance of the financial system, deposit rate should be compared to the two indicators, namely ROE and ROI. These indicators show how the economy performs. Through international comparative study, the ROI should be higher than the deposit rates, while the ROE is usually higher than the ROI. The deposit rates is usually closely linked to the national monetary or a macroeconomic policy, depending on the Central Bank.

Listed Corporations Data Analysis

From the Indonesian Capital Market Directory since 1989, it is possible to get series of uninterrupted data for 131 listed companies' performances in the Jakarta Stock Exchange or the JSX. Both the ROE and ROI are recorded since 1989 until 1998. But here the analysis is concentrated with the period between 1989 to 1996, the period before the crisis of 1997. In each year, the deposit rate in the banks is also recorded. Then the *geometrical averages* for the ROE, ROI and for the deposit rates are calculated. The results for the analysis are summarized in a table. Unfortunately the table of ROE and ROI for 131 corporations is quite long, so the complete list is not included in the present article. It could be made available on demand through internet. The table in the appendix, contains only 18 corporations, which are the best performing firms in the JSX, 1989-96.

To our surprise, since long before the crisis, there are only 18 corporations[13], where the level of ROE is higher than the deposit rates. By taking the ROI indicators, it is much worse. Simply using the *opportunity cost principle* it is better to put the fund in other activities or firms, which could be capable rendering higher returns. Instead of presenting the whole table, a short table on 18 best performing corporations is presented in the appendix, table AP3. From the 18 best firms, 11 are declared as FDI. It is disappointing, because most domestic firms are inferior to the FDI firms. A question is worth, what is the role of the difference between domestic and foreign interest rates in the performances of the FDI and local listed corporations? FDI uses foreign funds with lower rates, while local firms are with higher interest rates. Nonetheless the superiority of FDI is real.

[13] *The whole list of the 131 corporations was not reported here, but it is separately available, while the 17 best performing corporations were put in the appendix.*

Table 4

Bank credit for 131 corporations, in Rp. trillion and in its equivalent, $ billion

	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998
Rupiah T	2,88	3,55	5,46	7,78	12,54	14,98	21,37	27,56	71,70	90,37
In US$ B	1,627	1,926	2,800	3,833	6,008	6,933	9,504	11,766	15,419*	11,261*

Source: Summarized and calculated.
*(Note: * = by using end of the year exchange rate, T = trillion, B = billion)*

But to our further surprise, those corporations were still able to get credit from the banks. How could a bank award credit to firms with ROE less than the deposit rates? How does it come? This is a riddle in the Indonesian economy that must be clarified, which partly contributed to the causes of the crisis. This should be put under the public control in the future, based on the right provisions of the institutions. The public at large should be involved because they will pay the bill of any bailout for any kind of financial failure[14]. It should be a part of the good governance criteria, *the democratization of the supervision on the financial system*. But due to the required financial knowledge is limited to a small number of experts, there is a need to see the information provision as an act of public good provision, as the above arguments show. The coming financial crisis could be avoided or at least minimized, if the public vigilance exert pressure to the government. As it is evident after the crisis, the most severely hit group is the lowest social strata. The avoidance of the financial crisis is a pro-poor strategy.

By verifying Table 4, the level of credit for the 131 listed corporations in 1996 before the crisis broke up was equivalent to 11.766 billion US$ at the then exchange rates. At that time the level of credit for the small-scale industries in Indonesia was 49.291 trillion rupiah. So the credit for 131 corporations was 56 percent for thousands of the small-scale industries. And the credit for 131 corporations was on top of the funds they raised from the capital market. The riddle in the credit award for the less performing corporations, listed in the JSX, can be attributable to the fact that conglomerates own many banks and corporations. The many violations on LLL (legal lending limit) are valid indication of the following citation: <…, tycoons have favored raising capital from within the network, for instance from affiliated banks.[15]> Such practices should be abolished in the future, because it concerns not only economic efficiency reasons, but also social and political aspects. The abolition of the "relationship" banking practices will be touching the issue on the separation of baking business from other economic activities.

[14] *The interest of the bonds for bank recapitalization is charged to the government budget, starting from the fiscal year of 1999/2000. The society as a whole is footing the bill of the financial debacle. Poor us!*

[15] *"Asian Capitalism. The end of tycoons" in The Economist, April 29th, 2000, p.75*

Creation of Appropriate Institutions

In the case of urban land, there are two contradictory sides. The high price of land for private or business uses has erected a barrier for many households to own a decent house for the family, but it is a source of *windfall gains* for the landowners or the developers. The last groups really take advantages of the *external-economy* due to the construction of the public goods and the rising scarcity of well-equipped land. From the other side, the owners of the expropriated land have been incurred a substantial amount of losses due to the insufficient sum of the compensation of their land. But the perceived loss is due to the prevailing price after the construction of the infrastructures, where the land price has been substantially raised, containing pure rents. This is a misperception because it is due to inappropriate incentive system in the economy. But the *perceived disbenefited* social groups in the population are not aware on the embodied pure rents in the price of their land. The perception becomes real because the institutions in place have been embodying that misperception. This is a distorted situation but no efforts were made to rectify it. It needs a change in the evaluation system so that the true values and prices become the reality in the property market. A change in these evaluations leading to true values of the assets needs a change in institutions and policies in place too, which should be the bases of the new and correct perception.

In order to have a healthy economy, the Pareto optimality criteria should be the rule, especially if the situation resembles *a zero sum game* situation. But in general, the city economy is in a state of *positive sum game*. The problem is on the distribution of benefits and costs of the city development. So there should not be losers if the positive gains and costs were distributed rightly. The right distribution should be the watchword in the urban internal economic transformation. Within the scope of city economy, big infrastructure construction, is a real *structural change* to the regions (city + environment). The ring-road construction in Jakarta for example, entails a significant change to the city economy and also on the surrounding regions and economic environments. But inherently, due to the still inappropriate distribution of costs and benefits, it incurs losses for some group of the population, while other groups obtain windfall gains, which could be substantially high in monetary terms. This is not fair and unjust.

In order to satisfy the criterion of the Pareto optimality, it is here proposed the so-called *symmetrical treatment of externalities*. It is meant that anyone, who gains benefits should pay the bill of the infrastructure costs, while those who get negative impacts (due to the construction of the infrastructure) must be compensated adequately. The principle should be regarded as another expression of the *no pure rent* condition in the economy. The windfall gains in the urban land business should be regarded differently with the situation of *gold discovery in California*. A consistent use of the principle will lead to the right urban land price, resulting in the right price of houses in urban area with a rational proportion of land price. The land price is a source of many disputes in Indonesia, whether between the developers or the government with the landowners or between the developers with the government. From an unsystematic survey on newspaper publication between 1970 and 1996, 127 of 196 cases or 65 percent of land problems are due to the land price disputes[16]. So it is important to have the institutions dealing with systematic land value assessment, embodying both the justice principle and the economic efficiency reasons of the urban land prices, extendible to land price in general.

Private Ordering On Land Values or Prices

By referring to the NIE, *New Institutional Economics*, it is proposed another way to dispute resolution in the society. Usually, many of these go through the judicial system. But for the case of

[16] *See Dj. A. Simarmata (1997), p. 392.*

Indonesia this institution is still saddled with bad practices, leading to doubts on the efficiency of the judicial system. The NIE proposes the so-called *private ordering*[17] system. By this, the members of society resolve disputes without recourse to the judicial system, based on mutual arrangement between them. Private ordering needs transparent system in place, a well-accepted evaluation method of the land values and prices. It should not be a perfect one, but embodying the principle of just and healthy economy. Such system could reduce the social tensions, and leads to *less social cost for conflict resolution on land problems*. Due to the growing urbanization and extension of urbanized areas, without a well-established and well-designed institution in place, more urban land conflicts will be looming. So the benefits of establishing right institutions on the land value and prices lead not only to economic efficiency, but also to better social efficiency, promoting social peace due to the rise on social trust.

Asset market, namely property and equity market are not fully satisfying the assumed EMH. They are subject to situation of unsymmetrical information, raising the issue of *moral hazard* and *adverse selection*. Herd behavior and the bubble phenomena reign in the stock market, while the urban land market reside in an environment, rich on the externality and the bubble phenomena, too. Herd behavior is a sign of limited rationality on the part of market participants. Each participant is not as rational as the received ideas suppose. The simultaneous presence of unsymmetrical information and externality is an indication of the market imperfection, necessitating the provision of the right institutions.

A country has five elements of institutional endowments (North, 1981, 1990):

1. Its legislative and executive institutions
2. Its judicial institutions
3. Its administrative capabilities
4. Custom and other informal but broadly accepted norms
5. The character of the contending social interests within a society and the balance between them, including the role of ideology.

The definition of Khan *et al* on institution is simpler: *formal rules, informal constraints, and their enforcement characteristics*, which could be perceived as resulting from the five elements. Here the topic is concentrated on the impacts of the evaluation method to the market price of the assets, with an objective of the abolition of pure rents, so that the economy could be less inflicted by the bubble phenomena, every income is the result of productive works. On top of that, the case of negative impacts of the rising urban housing price on the poor should be an integral part of the policy. For the asset market as a whole it should be intended to prevent the occurrence of crisis, hence an instrument to maintain economic stability. The occurrence of capital market bubble should be avoided, not by the imposition of tax as in urban land market, but by the dissemination of the assessment evaluation methods and the required information. The dissemination of the methods and the information is intended to raise the awareness of the public on the true value of the equity market, leading the general participants to rational choice in the capital market with true prices. There should be a prescription of the necessary information for the evaluation of the equity securities. The government should conduct an inventory of the best-accepted methods from all over the world, and choose the best one for Indonesia, but subject to revision due to the possible improvement. It is sure that there will be critics on the proposed methodology, which might lead to a system of special method for each sector or sub-sector. But such a process will lead to wider participation from the members of the society at large for determining the best-accepted

[17] *Williamson, Oliver E. in : Proceedings of the World Bank, (1994)*

methodology. It is again a kind of democratization, which is a good thing for the society, better governance.

Specifically for the assessment of property market, the wide availability of mortgage instruments will be complementary to the previous institution. Mortgage market will be functioning in a competitive way in assessing the value and then the price of the property market. Such a competitive environment will lead to a better evaluation. Hence the development of the mortgage market in Indonesia is important, not only for the reasons of the completeness of the security components in the capital market, but also as another additional institution on the urban land market price assessment.

From the other government side, the determination of the land value and price for the purpose of land taxes should be based on the true economic value, using the previous methodology. It should not be only as a means for collecting high property tax income, but also as an instrument for erecting the true value of the land. The present system is still based on the objective for collecting the highest possible revenue. The stated urban land price for land taxation purpose does not conform to the prevailing market price, an indication of bad governance practice.

Another important institution to be created is the provision of general information on the benefits of investment in every sector of the economy. This should be an informal advocacy for a general pattern of good investment allocations between sectors in the economy. The data from CBS should be sharpened in fulfilling this objective, namely from I-O table. Table AP1 presents credit for several big-sectors, as for agriculture, industry, trades and services. As it seen in the table, the sum of total outstanding credit for trades and services is much higher than the credit for industry and agriculture in 1996, before the crisis. Table AP2 shows the outstanding credit for the property sector in 1995, which is much higher for agriculture. By using enlightened common sense, anybody will find a short of injustice, a case of misallocation of credits. The industries and agriculture employ a higher number of people, wider spatial impacts in the country, which is much more rural oriented. The property sector is more urban oriented, spatially concentrated. In hind-sight, it is clear that the property sectors have been oversupplied. The use of a broad indicator for the comparative advantage between sectors is presented in table AP5, which is derived from the 1990 I-O table. The figures in the table show that the profitability of the construction industries and trade is higher than that in the industrial group of textile, clothes and leather products, the industrial group of machinery, electrical appliances, and electronics rubber and plastics wares. The relative advantage of the two industry groups, namely construction and trade was confirmed by the flow of credit to the property sector and trade in the table AP1. The case of woods and forestry products should be considered in conjunction to the monopoly position of the license holders, where the export of logs were forbidden, leading to the protection of the industry groups. But, the indicators failed to show the potential profitability in many agriculture activities, as the rice and many other food crops production, which fall under the family enterprising. It seems that the indicators are only valid for formal and corporate sectors. The CBS should make more efforts on this front, by adjusting the data concerned with the above objective, providing a general indicator of the sectoral profitability of investment. Of course, the potential profitability indicators derived from the data are still lacking in the risk considerations, which should be the work of further detail study on investment.

Conclusion

Capital market and urban land market, or assets market, contain some imperfections due to several factors, amounting to inappropriate assets pricing, due to the *asymmetries or in the incomplete information*. There is asymmetry on the mastery of the methods of true value determination in urban land, a lack of knowledge on the subject in the public side. A simplified method should be made available to the public, a short of democratization on the urban land price assessment. There should be a dissemination of the phenomena, that urban land price is significantly determined by the provision of the public goods or public infrastructures, financed by taxes. A lot of other positive external effects due to the agglomeration have been at the source of the rising value of urban land, which is not due to the owners or holders of the land. As such, the landowners or landholders are not the legitimate beneficiaries of the whole capital gains on urban land. It contains pure economic rents, and if it becomes significant in the urban land price, the bubble phenomena take place, which is unstable and crisis-prone. A significant part of the pure rents should be expropriated for the society, for financing the infrastructures. It is more just, because if not, it is the public who pays the bill of the public goods or the public infrastructure construction costs. Such a system is expected to lead the urban land market to the lower true price. An economically justified urban land price will have another positive impact to the poor in the urban area, by enabling them to occupy and to own a decent house. If urban land price is allowed to contain substantial pure economic rents, speculation will be flourishing with its negative effects, the *bubble phenomena*, with its tendency to crisis when it bursts. Crisis hits the poor severely. Hence, to avoid the bubble phenomena will strengthen the crisis prevention, a pro-poor strategy. Through good institution provision, avoiding excessive pure economic rents in some sectors in the economy as a whole, it will contribute to more balanced investment allocations, which will lead the economy to *higher quality of growth* achievement. The case of urban land overpricing is mostly important for the developing countries like Indonesia, because the urbanization growth is comparatively higher in these countries compared to the industrialized countries. This is due to the present stage, where the level of urbanization is still low in comparison to the normal level in the developed countries.

As it was seen in the discussions, the unjustified urban land prices will be mostly against the urban poor, especially for access to a decent housing. The incorrectly widely held attitude on the urban land investment, which is really a speculation, could be a vehicle on becoming quickly rich for a small number of people, disposing a large sum of money, but *impoverishing* the already poor people in the urban areas. The very fast development of the slum areas in the big cities is an indication of the these processes.

The same thing should be applied to the capital market, providing appropriate systems or institutions to avoid the bubble phenomena, which is committed by overpricing the equity stocks or other securities in the capital market. As in the property market, bubble phenomena will lead to instability in the economy, a crisis. In turn, it is the poor who will be severely hit. The right institutions for the formation of securities true price should complement the capital market. The institutions should be aiming to minimize the *herd behavior phenomena*, triggering a crisis. One condition to that is the availability of all required information, transparency on all data and information to the investors. And, the availability of widely and proven accepted methods of equity value assessment, could be contributing to the irrationality of the market participants in the form of *herd behavior*. A set of corporate performance indicators, namely the ROE and ROI, should be referred to the deposit rates or lending rates in the banks, with an appropriate adjustment to the attending risks in the respective stocks or securities. If the ROI for a sufficiently long period for the equity securities is lower than the lending rates or deposit rates, it should be regarded as a sign of the inappropriateness of the investment. Either the investors should not buy the stocks or the banks should not accord credit for the firms concerned. The public should be empowered by publicly providing the accepted methods of value assessment and the wide availability of the required

information, the transparency criteria on the part of the corporations. All corporations in the capital market have to satisfy the good governance prerequisites.

Hence there should be a special effort from the government for making the urban land and property market healthy, as well as the financial market in general. The government should not follow the Walras advice for land nationalization, but just the nationalization of economic rents, especially here, the urban economic rents.

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Appendix Tables

Table AP1
Outstanding Credit (RP billion)
and Its Growth Rates in Several Big Sectors

	Tradable Goods				*Non-tradable Goods*			
	Agriculture		Industry		Trades		Services	
	Credit in Rp Billion	Growth, %	Credit in Rp Billion	Growth, %	Credit in Rp Billion	Growth, %	Credit in Rp Billion	Growth, %
1993	12057		51432		37794		35824	
1994	13860	14,9	60211	17,0	44372	17,4	50809	41,8
1995	15525	12,0	72088	19,7	54224	22,2	66584	30,9
1996	17630	13,5	78850	9,3	70586	30,2	91655	37,6
1997	26002	47,5	111679	41,6	82264	16,5	113569	23,9
1998	39308	51,2	171668	53,7	96364	17,1	139124	22,5

Source: Adapted from: Statistics of Economy and Finance of Indonesia, Bank Indonesia, October 1999.

Table AP2
Outstanding Credit and its Growth for Property, 1992-1996
(in billion Rupiah)

Year	Outstanding Credit	Growth
1992	16.374	-
1993	21.900	33,5
1994	33.400	52,5
1995	48.600	45,5
1996	53.800	10,7

Source: Bank Indonesia, cited in Business News 6040/30-7-1997.

Table AP3
Development of ROE for 17 nonbank corporations,
having ROE > average deposit rates, within the period of 1989-1996

Corporation	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	AV 89-96
Deposit Rate	*18,63*	*17,3*	*23,32*	*19,6*	*14,55*	*12,53*	*16,72*	*17,26*	*20,01*	*> 20*	17,23
Charoen Pokphand Indonesia*	6,43	*22,64*	18,9	*21,72*	*27,98*	*25,98*	*23,09*	*18,21*	-27,66	-18,6	19,17
Petrosea *	*54,52*	*19,27*	19,2	*22,44*	*24,42*	*22,44*	7,66	9,58	*37,32*	*42,42*	19,16
Delta Djakarta *	*23,95*	*36,49*	*43,25*	*29,36*	*33,75*	*34,17*	*34,46*	*21,54*	-10,94	14,82	31,42
Multi Bintang Indonesia *	*22,1*	*28,84*	*31,21*	*29,25*	*40,33*	*40,3*	*41,47*	*35,61*	*23,62*	10,16	32,97
Sari Husada	17,43	*18,41*	20,16	19,22	*24,43*	*23,43*	*27,98*	*33,00*	*26,94*	4,67	22,51
BAT Indonesia *	10,98	*20,36*	11,55	12,75	*19,02*	*31,92*	*51,77*	*56,2*	*23,41*	18,02	22,16
Indo-Rama Synthetics *	*33,2*	16,08	17,85	*24,51*	*19,92*	*19,94*	*21,12*	*18,25*	12,91	0,09	20,85
Polysindo Eka Perkasa	*76,89*	*26,41*	*23,26*	*28,29*	*16,95*	*15,93*	*24,16*	11,12	1,27	-193,99	23,62
Unggul Indah Corporation *	*24,79*	*30,35*	*27,94*	*20,44*	*16,6*	*13,38*	13,05	15,25	1,91	13,87	19,27
Ekadharma Tape Industries	*33,22*	*22,09*	18,97	*21,22*	*17,35*	*21,22*	*21,22*	*21,22*	10,48	*33,14*	21,69
Good Year Indonesia *	15,74	*28,24*	*26,97*	*27,79*	*25,05*	*27,79*	*27,79*	*27,79*	4,12	*28,76*	25,51
Modern Photo Film Company	14,23	*19,52*	*26,69*	17,21	*19,26*	*21,39*	*21,63*	*20,48*	-9,54	-29,72	19,76
Dankos Laboratories	15,97	5,71	15,26	*24,91*	*32,24*	*22,6*	*20,47*	*20,14*	0,93	-159,94	17,87
Merck Indonesia *	*24,25*	*33,38*	*42,89*	*57,22*	*64,26*	*74,12*	*79,28*	*72,1*	*63,81*	*32,2*	52,08
Schering Plough Indonesia *	*52,32*	*31,56*	18,22	*30,14*	*32,57*	*37,19*	*36,59*	*22,27*	*25,38*	-4,54	31,19
Unilever Indonesia *	*39,05*	*47,26*	*51,39*	*58,82*	*57,65*	*55,72*	*53,27*	*42,39*	*43,86*	*40,16*	50,22
Sorini Corporation	*37,82*	*35,09*	22,14	*20,77*	*24,18*	*22,42*	13,62	9,53	-270,5	n.a	21,34

Source: Excerpted from the collected ROE table for 131 firms. (= Foreign Investment 11)*

Table AP4
A developer house types and land cost portion in the house price

House type	Area [m^2]		Cost [thousand Rp]		Total house price	Land cost portion, %
	Land	Floor	Land	Structure		
Lawu I	162	62	85 860	38 440	127 030	67.59
Lawu II	162	68	85 860	42 160	131 265	65.41
Lawu III	162	90	85 860	55 800	146 820	58.48
Arjuna I	216	78	114 480	48 360	166 070	68.93
Arjuna II	216	81	114 480	50 220	168 190	68.07
Arjuna IV	216	88	114 480	54 560	173 135	66.12
Arjuna V	216	103	114 480	63 860	183 740	62.31
Semeru I	315	112	176 400	73 920	255 205	69.12
Semeru II	315	120	178 400	79 200	261 220	67.53
Semeru III	315	124	178 400	81 840	264 235	66.76
Semeru IV	315	123	178 400	81 180	263 480	66.95
Semeru V	315	167	178 400	110 220	296 590	59.48
Merapi I	345	198	203 550	139 590	356 380	57.12
Merapi II	345	221	203 550	155 805	374 865	54.30
Kelud I	450	198	265 500	139 590	416 405	63.76
Kelud II	450	210	265 500	148 050	426 050	62.32
Kelud III	450	221	265 500	155 805	434 890	61.05

Source: A developer's (the name is kept unrevealed) flier (1996)

Table AP5
Some Indonesian Economic Incentives Index represented
by Net Operating Profits in the Value Added (1990 I-O table)

Product/ Sector	Percentage of Net Operating Profits in Value Added (1-7), in I-O
1. Woods and other Forestry Products	77,93
2. Textile, clothes and leather products	43,52
3. Machinery, electrical appl. and Electronics	41,52
4. Rubber and plastics wares	44,94
5. Trading (non-tradable)	69,50
6. Hotel & Restaurants (non-tradable)	61,20
7. Construction and property (non-tradable)	75,43

Source: Calculated from I-O 1990 table, CBS, by Simarmata

Table AP6a.
German Land-Price Growth Index, between 1950-1970[18]

	1950	1960	1965	1970	Grwth, %
Land Price	100	310	939	1201	13.23408
Housing Rent	100	132	175	242	4.517922
Housing Const. Costs	100	157	209	269	5.072149
CPI	100	120	138	157	2.281004

Table AP6b.
JAPAN between 1955-1990, AssetPrice Ratio and its Growth, %[19]

	Ratio	Growth
Resident Land Price Ratio, 6cities	200	16.34393
Stock Price Ratio	90	13.71965
CPI Ratio	8	6.121302

[18] *See Simarmata, Dj. A. (1997), op cit, Table 2.2, p. 73*
[19] *Nishimura, Kiyohiko G., et.al. : "Distortionary Taxation, Excessive Price Sensitivity, and Japanese Land Prices," NBER, Cambridge, MA 02138, July 1997, rearranged into tabular form by the author, from p. 1*

Complementary Note 1.

A Note on Concerns and Quotations over Asset Price:

Table AP6 shows the growth rate of land price in Germany between 1950-1970, and in Japan between 1955-1990. The table on Japan contains also the growth rates of asset price. It is seen that in land price growth rate is higher in Japan than in Germany, but it is higher in the 6 locations in Jakarta (even though with a shorter time period, between 1983-1996, see table 3).

With with a similar concern but a wider scope, we can see the following citation from Alan Greenspan and Charles Goodhart on the necessity of a new insight on the assets price inflation[20]:

> < Mr. Greenspan told the gathering of central bankers that the prices of shares and property are playing an increasing role in driving the economies; and thus that central bankers need to pay more attention to asset prices. … …
>
> … Charles Goodhart, a member of the Bank of England's monetary policy committee, presented a controversial paper on asset prices at a Eurostat conference this week. He argued that central bankers have focussed on too narrow a measure of inflation and that the prices of houses and financial assets should be included in a broader inflation index.> *The Economist, September 4th 1999*, p. 82.

[20] *The author of this article has expressed a similar concern in his book, see: Simarmata, Dj. A., (1997), p. 9*

Complementary Note 2:

A Note on Walras' Land Value:

Thorugh his elaboration, Walras found the price of a land A, with yearly rental value of a, with an yearly increment in rent of z :

$$\boxed{A = \frac{a}{i} + \frac{az}{i(1+i)^m} x \frac{(1+i)^m - (1+z)^m}{i-z}}$$

If z>i, the formula can restated in the following form, and if m $\rightarrow \propto$, the value of A, or the price of land can be very high, A$\rightarrow \propto$.

$$A = \frac{a}{i} x \frac{z\left(\frac{1+z}{1+i}\right)^m - i}{z-i}$$

In case of the equality of yearly rental growth to interest rates, the above formula changed into the following form:

$$A = \frac{a}{i} + \frac{ma}{1+i}$$

which again give the very big value of A if m $\rightarrow \propto$.

Based on the result of his mathematical elaboration, Walras proposed to isolate the land market from the free market, through *nationalization of land*.

By using the *incentive theory arguments*, I refuse to nationalize the land, but instead, *nationalize the rents* of the land. This is more amenable to the market system in the economy, through embodiment of the economic incentive systems. One of the proposals from the economic incentive theory is to reduce the pure economic rents to zero, which is among others found in the urban land market.

A Note on the impacts of land value in capital, using CGE

The author used the CGE model for analyzing the impacts of the rise of land value in the economic growth potential. The result of the analysis shows an irregular growth pattern, because at some land value proportions in the capital, the growth potential is unlimitedly high. The simulation was repeated by using many (hundred) land value proportions, with analog results in the irregularity pattern. This leads the author to the guess, that the impacts of land value in CGE model could give rise to the *chaotic value* results. Chaotic results could come out of even a very simple model, as presented in the work of Abraham-Frois et Berrebi [1995].