1 INDONESIA

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1.1 Introduction

The Republic of Indonesia is an archipelago located between the Asian Continent and Australia. The territory consists of about 13,700 islands and has a total area of 735,362 miles or 1,919,317 square km. As one of the East Asia's prospective nation (what is called as the emerging giant), Indonesia is enjoying a continuous high growth since the beginning of the five years plan in 1969. On the other hand, although its economic growth is making a steep increase, many problems are also arising, namely, national income inequality. Income inequality occurs not only among income classes within a country, but also among regions, i.e., the West and the East.

Rising from a totally devastated situation and from the poorest economic condition after Independence in 1966, when the communist party was ousted by their abortive coup and their governmental mismanagement, Indonesia has been classified as a newly industrialized economy (NIEs). Furthermore, at the beginning of the 1990s, President Soeharto awarded for achieving the country's success in food production, especially rice production, and in family planning program. These are very important achievements for Indonesian people, because Indonesia was once one of the largest importers of rice and a country with the fastest population growth along with two other giant Asian countries (i.e., India and China).

Recently, Indonesia completed its first 25 year long-term development plan. Comparing the situation with that at the end of the old regime in 1966, the new government has successfully reduced the poverty rate and its dependency on agriculture, shifting to higher technology manufacturing.

As a member of OPEC nations, Indonesia has successfully invested its capital revenue from oil and gas sectors to other industrial sectors and these manufacturing sectors in turn produced export goods and satisfied the domestic needs. The changing dependency on oil and gas sectors prevented Indonesia from being plunged into another calamity period stemming from declining oil prices in the early 1980's.

Several fiscal policies implemented during the 1980s support the adjustment process of changing Indonesia's dependency on oil and gas sectors. Several deregulatory measures were enacted with respect to custom and duties, trading and investment, and most importantly the tax system. The tax reform policy has expanded the range of people subject to pay tax, thereby successfully increasing tax revenue.

1.2 Overview of Macroeconomic Activity and Fiscal Position

In the midst of an abortive coup attempted by the communist party and the following collapse of the old regime in 1966, the economy of Indonesia was already in confusion as a consequence of irresponsible government policies. At that time, growth of GDP reached only 2.8 % per annum, investment as a percentage of GDP was declining, and economic infrastructures were devastated.

During 1960 and 1965, the economy did not grow and caused per capita income to plunge into stagnation (Table 1.1, line 2). The critical factor that brought the Indonesian economy into the depths of misery was the rocketing of inflation rate which reached 594% in 1965 (line 6) and 635% in 1966. One of contributing factors to this phenomenon was the government's, printing of money, as seen in increases in money supply (M1) from 37% in 1960 to 302% in 1965 (line 3). Furthermore, exports declined in the early 1960's while imports increased. As a result, budget deficits rose from 17% of total expenditure in 1960 to 63% in 1965 (line 5).

The New Order Government brought Indonesia as one of new tigers in Asia. The continuous high growth since the first five-year planning has enabled Indonesia to reach per capita GDP of US$1,300.

The period from 1966 to the end of 1970 was a transition period for the new regime in preparing the process for economic development. Over this period, all the government efforts were concentrated to control inflation rate, to reinstate relationships with donor countries and institutions to borrow money and to induce foreign investment, and to re-establish all infrastructures. Thus, the new government launched a five year plan in 1969 which was also the first stage of the 25-year long-term national plan.

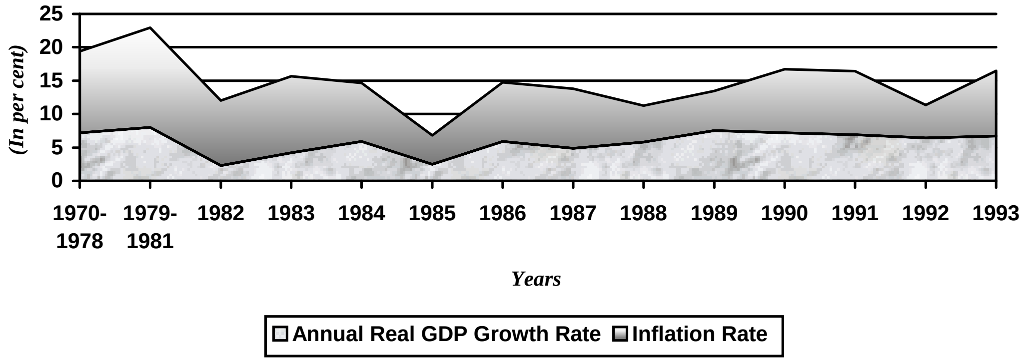
During the first decade of the long-term national plan, oil and gas were exploited intensively and the revenue from these sectors became an important source in financing the Indonesian annual budget. The oil boom in the early 1970s boosted Indonesian GDP: specifically international petroleum prices quadrupled and brought a sudden increase in revenue from the oil and gas sectors. Since then, the annual budget heavily depended on revenue from these sectors and the government became less interested in sustaining development of other sectors. The inflation rate escalated to 33.3 % in 1974, but the government quickly implemented several appropriate monetary policies that brought inflation rate down to 6.8 %. During the 1970s the

Table 1.1 Indicators of Indonesia Economic Development, 1960-1965

	1960	1961	1962	1963	1964	1965
1. GNP (billion Rp.), 1960 prices	391	407	403	396	407	430
2. Per capita income, % change	-1.6	1.7	-3.0	-4.0	0.3	3.2
3. Money supply *M1: % increase	37	41	101	94	156	302
4. % increase due to budget deficit	19	134	97	115	104	90
5. Budget deficit as % of expenditure	17	30	39	51	58	63
6. Inflation (CPI, % increase)	20	95	156	129	135	594

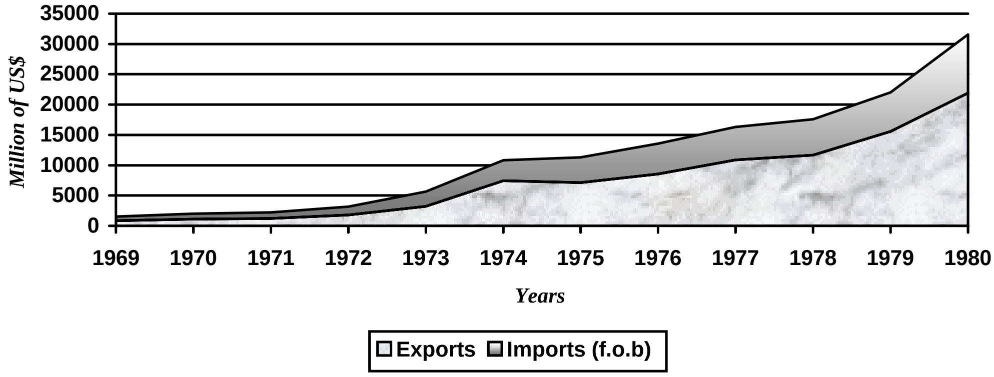
Source: Bank Indonesia Financial Yearly Report 1960-1965.

Figure 1.1 GDP Growth and Inflation Rate



Source: Bank Indonesia, Indonesian Financial Statistics and Weekly Reports.

Figure 1.2 Indonesia's Imports and Exports 1969-1980



Source: International Financial Statistics Yearbook 1996.

Indonesian government seemed to have suffered a *Dutch Disease*[1]. Fortunately, when the price of oil dropped sharply, the Indonesian government was able to adjust quickly by cutting back on expenditure, rescheduling and canceling various projects, devaluating the rupiah in April 1983, and carrying out tax, customs, and banking reforms.

The result of the structural adjustment mentioned above together with other macroeconomic policy such as fiscal policies and foreign borrowing policy improved the Indonesian economy. Real GDP growth rate, which declined to the lowest level of 2.3 % in 1982 increased to 4.2 % in 1983. In the following five years, from 1984 to 1988, the average real growth rate was 5.0 % per annum. Inflation, which increased up to 9.7 % and 11.5 % in 1982 and 1983 respectively, declined to an average of 7.3 % per annum in the following five years.

1.2.1. Macroeconomic Activity

A. International Environment

A.1 State's Trade Balance

After the first year of the five years development plan, Indonesia had heavily depended on revenue from the oil and gas sectors. Exports, dominated by the oil and gas sectors, increase sharply from 1969 to the end of 1973 due to oil crisis period and timber boom period. Although oil and gas dominated export revenues during the 1970s period, non-oil and gas sectors also increased due to the hike in international demand for commodities.

However, the following events undermined Indonesian exports. First, the oil price could not maintain its high level, and declined in the early 1980s. Second, the revenue from the non-oil and gas exports also dropped due to a depression in the world economy there by giving more damage to the Indonesian budget. Third, the government devaluated Indonesian currency against US dollar in late 1978. Finally, the Pertamina crisis broke out. Pertamina, a state owned major oil company, borrowed a huge amount of funds from international financial institutions but misused them by investing the funds in sectors not related to oil productions. The result was a sharp decline in the Indonesian exports in 1982. Exports decreased by 15 % or specifically from US$23,348 million in 1981 to US$19,747 million in 1982 (Table 1.2). At this point, Indonesia seemed to be suffering from the Dutch Disease. Fortunately, the government quickly

[1] In 1960, a substantial reserve of natural gas was discovered in the Netherlands. The sudden increase in exports and the surplus of its balance of payments promised a great welfare. However, during 1970s the Dutch economy suffered rising inflation, declining exports of manufactured goods, lower rates of income growth, and increasing unemployment rate. Such symptoms are called Dutch Disease, a nickname of the oil-boom syndrome.

Table 1.2 The Indonesian Trade Balance 1981-1994

(millions of US$)

Year	Exports (f.o.b)	% Growth	Imports (f.o.b)	% Growth	Trade balance
(1)	(2)	(3)	(4)	(5)	(6)=(2-4)
1981	23,348.0		16,542.0		6,806.0
1982	19,747.0	-15	17,854.0	8	1,893.0
1983	18,689.0	-5	17,726.0	0	963.0
1984	20,754.0	11	15,047.0	-15	5,707.0
1985	18,527.0	-11	12,705.0	-16	5,822.0
1986	14,396.0	-22	11,938.0	-6	2,458.0
1987	17,206.0	20	12,532.0	5	4,674.0
1988	19,509.0	13	13,831.0	10	5,678.0
1989	22,974.0	18	16,310.0	18	6,664.0
1990	26,807.0	17	21,455.0	32	5,352.0
1991	29,635.0	11	24,834.0	16	4,801.0
1992	33,796.0	14	26,774.0	8	7,022.0
1993	36,607.0	8	28,376.0	6	8,231.0
1994	40,223.0	10	32,322.0	14	7,901.0

Source: International Financial Statistics Yearbook 1996.

Table 1.3 The Indonesian Current Account Balance 1981-1994

(million US$)

Year	Balance on Goods and Services	Net Income	Net Current Transfer	Current Account Balance
(1)	(2)	(3)	(4)	(5)=(2+3+4)
1981	2,257.0	-3,073.0	250.0	-566.0
1982	-2,465.0	-2,993.0	134.0	-5,324.0
1983	-2,802.0	-3,650.0	114.0	-6,338.0
1984	2,038.0	-4,061.0	167.0	-1,856.0
1985	1,531.0	-3,542.0	88.0	-1,923.0
1986	-954.0	-3,216.0	259.0	-3,911.0
1987	1,299.0	-3,654.0	257.0	-2,098.0
1988	2,441.0	-4,092.0	254.0	-1,397.0
1989	3,100.0	-4,547.0	339.0	-1,108.0
1990	1,784.0	-5,190.0	418.0	-2,988.0
1991	1,059.0	-5,581.0	262.0	-4,260.0
1992	2,313.0	-5,664.0	571.0	-2,780.0
1993	3,338.0	-5,981.0	537.0	-2,106.0
1994	3,173.0	-6,582.0	619.0	-2,790.0

Source: International Financial Statistics Yearbook 1996.

took actions by implementing some fiscal policies to cope with such problems. First, the government rescheduled large development projects, and reduced subsidies for food and basic needs. Second, for the third time, the government devaluated the currency against the US dollar by 38 % in March 1983 to stimulate non-oil exports, and also implemented J-curve effects of the devaluation. Finally, the government proclaimed a new tax law in January 1984 to increase domestic revenue, while it continued to search for foreign loans to raise funds for development programs.

A.2 State Current Account Balance

The decline of the oil price in the international market together with the decrease in the international commodity trade created enormous current account deficit during 1982 and 1983. The current account deficits suddenly increased from US$566 million in 1981 to minus US$5,324 million in 1982 and further down to minus US$6,338 million in 1983. The devaluation of rupiah against the US dollar in 1989 had an effect on import reduction, and successfully on improving current account balance up to minus US$1,856 million (Table 1.3). The success of devaluation policy to reduction of current account deficits also controls inflation rate. But the current account deficits was accompanied by increased sharply again in the early 1990s, from US$ 1,108 million in 1989 to US$2,988 million in 1990, and continued to US$4,260 million in 1991. Sudden increase in Indonesia's current account deficit during the 1990s was due to the world economic recession and the tight monetary policy.

A.3 Exchange Rate and Exchange System

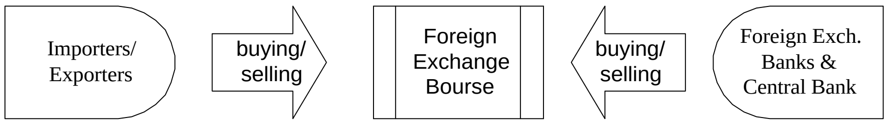
From 1971 to present, the government deregulated its foreign exchange policy three times, and also devaluated the rupiah twice against US dollar. Rupiah was once pegged to the US dollar until the end of 1977. The primary purpose of deregulating the foreign exchange policy and devaluating the rupiah was to encourage exports and to reduce the import of goods and services.

a. The First Deregulation Policy

The early 1970s was a period of economic transition and reconstruction; i.e., a transition between the old regime and the new order government, and a reconstruction of the most deteriorated infrastructure abandoned by the old regime. After the implementation of the first five-year development plan, the holding, selling, and purchasing of foreign currencies were no longer subject to restriction. Thus, exporters/importers could trade foreign currencies through Foreign Exchange Bourse. In fact, the trading of foreign currencies between the central bank (Bank Indonesia) and private and state-owned banks was realized through a Foreign Exchange Bourse. Until 1970, the foreign exchange rate had been set by the Foreign Exchange Bourse.

After the first devaluation policy in 1971, the exchange rate was no longer set by Foreign Exchange Bourse, but by the central bank. Furthermore, the government devaluated the Rupiah by ten % against the US dollar resulting at Rp.415 versus the US dollar. This policy was continued until the end of 1977 (Table 1.4).

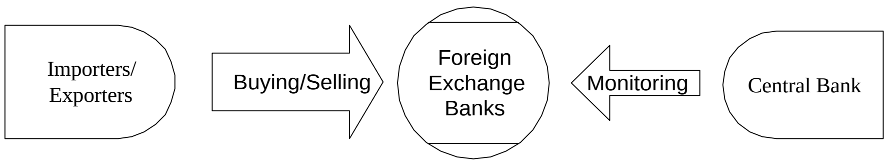
Foreign Exchange Trading System from 1967 to 1988



b. The Second Deregulation Policy

As the second step of the devaluation period, the government changed its policy of the foreign exchange system from pegging the rupiah to the US dollar to pegging the Rupiah to a basket of several foreign currencies, namely currencies of Indonesia's main trading partners. However, the US dollar was still the main currency to pegged. Furthermore, included in the same deregulation package was the rupiah's devaluation by 33.6 % against the US dollar at Rp.625 to one US dollar. With the devaluation policy, the government expected to improve the trade balance and to increase the price competitiveness of its export commodities in the international markets.

Foreign Exchange Trading System from 1989 to present



c. The Third Deregulation Policy

Through such deregulation policy, exporters no longer depended on the central bank regarding the foreign exchange payment process. In fact, they were allowed to manage their exports proceeding independently. In addition, the central bank also provided export credits with subsidized rates. Regarding the foreign exchange system, in 1989 the government swept out the existing Foreign Exchange Bourse, and conducted the foreign exchange transaction

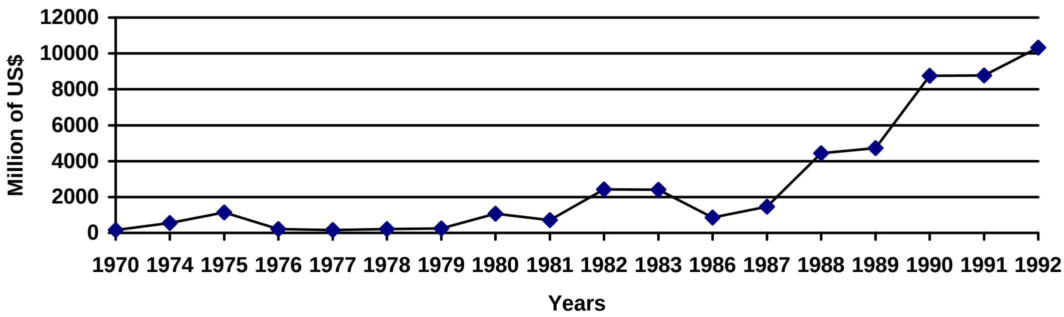
Table 1.4 The Indonesian Exchange Rate against US$ and SDR 1969-1993

(in Rupiah)

	Year				
	1st Five Year Development Plan (FYDP)				
	1969	1970	1971	1972	1973
1 SDR	326	378	450.6	450.6	500.6
1 US Dollar	326	378	415	415	415
2nd FYDP	1974	1975	1976	1977	1978
1 SDR	508.1	485.8	482.2	504.1	814.2
1 US Dollar	415	415	415	415	625
3rd FYDP	1979	1980	1981	1982	1983
1 SDR	826	799.4	749.6	763.9	1,040.7
1 US Dollar	627	626.8	644	692.5	994
4th FYDP	1984	1985	1986	1987	1988
1 SDR	1,052.7	1,235.7	2,007.3	2,340.8	2,329.4
1 US Dollar	1,074	1,125	1,641	1,650	1,731
5th FYDP	1989	1990	1991	1992	1993
1 SDR	2,361.5	2,704.5	2,849.4	2,835.3	2,898.2
1 US Dollar	1,797	1,901	1,992	2,062	2,110

Source: International Financial Statistics Yearbook 1996

Figure 1.3 Foreign direct Investment (Approval Base) 1970-1992



Source: International Monetary Fund, Balance of Payments Statistical Yearbook 1996.

in the dealing room. Furthermore, the government removed the ceilings of bank's borrowing from abroad and applied the net foreign exchange open position regulation as one of the ways to reduce bank's risks. In 1989, the government also introduced swap transactions between foreign exchange banks and the central bank; the two types of swaps that were introduced are liquidity swap and investment swap. Regarding to the foreign exchange, in 1989 the government introduced the managed-floating rate principle which is based on a basket of currencies in both of domestic and international foreign exchange markets.

A.4 Foreign Direct Investment

Foreign Direct Investment (FDI) played an important role during the period of transition and reconstruction in the early 1970s. In the 1970s, the highest inflow of FDI was recorded in 1975. The most important event for both foreign and domestic investment environment during the 1970s was the establishment of the Capital Investment Coordination Board under with the governmental institution obtained a special authority to evaluate capital investment applications and to approve adequate investment proposals.

During the 1980s, many firms were expected to improve their efficiency and to produce more export-oriented products. The government supported this environment by introducing fiscal incentives such as tax reform packages in 1983. In 1985, the government announced a new deregulation package in the custom and duty sector. The new policy enabled the government to cut the long bureaucratic processing with respect to export and import documents that usually delayed export and import schedules. This long bureaucratic document processing procedures had an effect to increase prices in export and import commodities. Furthermore, by issuing the new deregulation policy, the government handed over the customs processing responsibility from Directorate of Custom and Duty Division (under the Ministry of Finance) to Swiss Surveyor SGS.

Among East Asian countries, the Indonesian investment, as a share of GDP, remained low. Even among ASEAN countries, the Indonesian investment, as a share of GDP, stayed the second lowest after the Philippines. During the period from 1990 to 1995, the percentage did not increase and remained at 28.5 %. The percentage even decreased from 27.3 % in 1992 to 25.9 % in 1993 (Table 1.5). This phenomenon is attributable to the world depression in the international commodities market on which the Indonesian economy depends as the country's secondary source of revenue; that is revenue from such exports as woods, rubbers, coffees, and tobaccos.

A.5 Borrowing from Abroad

Table 1.5 Investment as A Share of GDP in East-Asia

(%)

COUNTRY		1990	1991	1992	1993	1994	1995
Indonesia	**GDFI/GDP**	28.4	28.1	27.3	25.9	27.8	28.8
	Private I/GDP	19.2	18.5	17.7	16.1	18.1	19.3
	Public I/GDP	9.3	9.6	9.5	9.8	9.7	9.5
Korea	**GDFI/GDP**	37.1	38.4	36.6	36	35.7	36.6
	Private I/GDP	29.6	29.5	27.3	27.2	27	26.9
	Public I/GDP	7.4	9	9.3	8.8	8.7	9.8
Malaysia	**GDFI/GDP**	32.4	33.4	34.7	35.4	38.5	40
	Private I/GDP	20.9	22.7	23.2	23.2	25.2	26.5
	Public I/GDP	11.5	10.7	11.5	12.3	13.3	13.5
Papua New Guinea	**GDFI/GDP**	25.1	28	23.8	18.8	13.9	19
	Private I/GDP	20	23.3	18.6	12.5	11.1	15.5
	Public I/GDP	5.1	4.7	5.2	6.3	2.8	3.5
Philippines	**GDFI/GDP**	23.1	20	20.9	24.3	23.6	22.5
	Private I/GDP	18.9	15.9	16	19.3	18.7	17.9
	Public I/GDP	4.2	4.1	4.9	5	4.9	4.6
Thailand	**GDFI/GDP**	40.2	41.6	38.7	40.2	41	42.8
	Private I/GDP	34.1	34.4	30.7	32.3	32.6	34.2
	Public I/GDP	6.1	7.2	8	7.9	8.4	8.6

Source: International Finance Corporation, Trends in Private Investment in Developing Countries, Statistics for 1970-1995, Discussion Paper Number 31.

One factor that contributed to Indonesia's recovery from the *Dutch Disease* during the early 1980s was its low debt-service ratio. When the world oil price declined and the international commodity markets were sluggish, Indonesia accumulated deficits in its current account balance (Table 1.3). The direct effect of the deficit was a hike in its external debt. In 1988, total of the country's external debt was almost double from the amount of 1980 (Table 1.6). Although the government managed its debt by using fiscal policy tools to encourage exports and to reduce imports, its debt service ratio tended to escalate (greater than 40% of GDP). Fortunately, the government was able to return the principal debt and the interest according to the repayment schedule and the Indonesian debt had not been subject to rescheduling, otherwise, it could have decreased the international debtors' confidence in the Indonesian government's ability to return their funds (Table 1.6).

Until the middle of the 1980s, the United States was the largest debt holder among the Indonesian debtor, especially for the long-term debt. However, since 1988, Japan has replaced the US position (Table 1.7).

A.6 Foreign Aid

Unlike the old regime, which had a weakness with foreign aids, the New Order government was very open to the donor countries. In the first year of the 1st Five-Year Development Plan, the government began to include foreign aid as development-budget revenue. After then, the role of foreign aid became an important part of Indonesian economic development. However, foreign aid became less important as a main source of government's revenue during the oil boom period. The role of foreign aid revived again during the recession period in early 1981 when the international commodity market prices dropped sharply.

B. Domestic Environment

B.1 Economic Growth Rate

During the transition period from the old regime to the New Order government, the Indonesian growth rate jumped up rapidly from an average growth of 2.8 % during the 1960s to 7.2 % in the period between 1970 and 1978, and proceeded to increase at a level of 8 % in the period between 1979 and 1981. However, in 1982, the growth rate fell down to a level which was worse than that in the old regime. Fortunately, an economic expert team called "the technocrat" who worked for the Indonesian government quickly launched series of fiscal policies. The policies successfully boosted the economy to the level of 4.2 % in 1983, and

Table 1.6 The Indonesian Debt Outstanding (LDOD) and Repayment 1970-1995

(in million of US$)

Year	Public and Publicity Guaranteed		Private Debt			
	Official Debt		Private Debt		Non Guaranteed	
	LDOD	Repayment	LDOD	Repayment	LDOD	Repayment
(1)	(2)	(3)	(4)	(5)	(6)	(7)
1970	22	2,250	37	282	195	461
1980	324	9,563	616	5,458	695	3,142
1988	1,304	26,378	3,118	14,805	1,793	5,545
1989	1,341	28,103	3,597	16,159	2,067	6,556
1990	1,586	33,007	3,001	14,975	5,015	10,261
1991	1,777	37,589	2,865	14,303	4,814	13,176
1992	1,992	40,070	3,191	13,596	5,703	16,281
1993	2,143	44,282	3,554	12,850	1,195	14,029
1994	3,291	49,976	2,259	13,915	4,920	15,543
1995	3,138	51,231	2,579	14,116	6,963	20,134

Source: IBRD/The World Bank, Global Development Finance 1997.

Table 1.7 The Proportion of Indonesian Debt's Structureper Currency 1970-1995

(%)

Year	Germany	French	Japan	UK	Swiss	USA	Multiple	SDR	Others
1970	3.9	4.5	11.5	2.2	0.9	36.1	0.0	0.0	40.9
1980	7.8	4.0	20.0	0.8	0.7	43.5	8.6	0.0	14.7
1988	5.5	2.9	39.9	1.9	0.7	18.5	23.8	0.1	6.8
1989	5.2	2.8	34.4	1.5	0.4	24.6	24.6	0.0	6.4
1990	5.0	3.4	34.6	1.4	0.4	20.9	27.3	0.0	7.0
1991	4.9	3.6	35.7	1.2	0.4	19.4	28.0	0.0	6.7
1992	4.7	3.7	36.4	1.0	0.4	19.9	27.6	0.0	6.3
1993	4.1	3.3	37.6	0.9	0.5	19.9	28.1	0.0	5.6
1994	4.8	3.3	38.0	0.9	0.7	20.0	26.7	0.0	5.5
1995	4.9	3.7	35.4	0.8	0.7	21.5	27.2	0.0	5.7

Source: IBRD/The World Bank, Global Development Finance 1997.

continued to maintain the average of 5.0 % during the period between 1984 to 1988, and 7.5 % in 1989. However, the growth of GDP gradually decreased to 7.2 % in 1990, 6.9 % in 1991 and stopped at the level of 6.4 % in 1992. In 1993, the GDP growth rate increased to the level of 6.7 %.

B.2 Inflation Rate

At the end of the old regime, inflation rate surged to 635 %. The New Order government successfully reduced it, to a far lower level of 8.8 %, at the beginning of the 1st Five-Year Development Plan. However, as the economy grew during the oil boom period, it became overheated and, as a result, the inflation rate hiked to 33.3 % in 1974. By using several fiscal-oriented tools, the government successfully reduced the inflation rate as low as 6.7 % in 1975. During the second oil boom period at the end of the 1970s, the inflation rate went up to 14.9 %. During the economic crisis at the beginning of the 1980s, the government made great efforts to reduce inflation rate to 9.70 % by cutting the deficit in its current account balance (Table 1.3). However, the inflation increased again to 11.46 % in 1983. Since 1984, the inflation rate has remained stable at a single-digit level.

B.3 Consumption, Investment and Capital Stock

Since the beginning of the 1st Five-Year Development Plan, private consumption has always exceeded government consumption, and the gap has widened during the last five years. The large jump in private consumption began in 1979 when total consumption increased by more than 40 % from Rp.13,850 billion in 1978 to Rp.19,514 billion in 1979. Another jump occurred in 1993 when consumption increased by more than 35 % from Rp.135,880 billions to Rp.183,531 billions

As stated in *A.4* above, Indonesia was one of the lowest countries among ASEAN countries in terms of the share of investment to GDP. One of the many reasons for this fact was the characteristic of Indonesian investment, which tends to be less export-oriented than foreign investment. Domestic investors always think of the domestic market first. This stereotype characteristic was blamed as one of several factors that brought Indonesian-export revenue to decline from US$26.5 billion for the approved projects in the 1990-1992 period to US$17.5 billion for the approved projects in the 1993-1995 period. Although the share of investments in the human-resource and technology-intensive sectors increased from 29 % to 56 %, the share of annual exports (estimated value) increased only from 31 % to 35 %. This fact also supports the hypothesis above.

Table 1.8 Gross Domestic Product

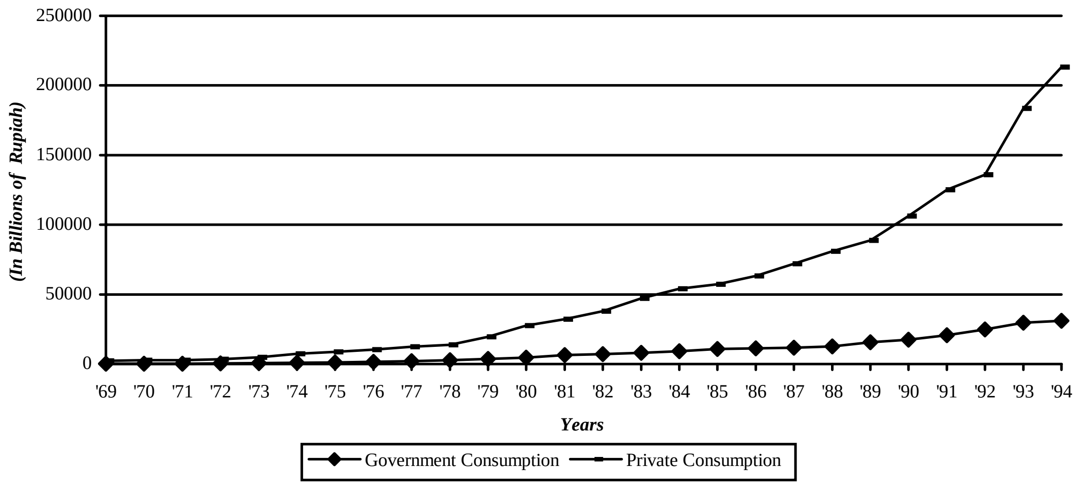
(billions of Rp)

FISCAL YEAR	GROSS DOMESTIC PRODUCT	% *)
THE 1st FIVE YEAR DEVELOPMENT PLAN		
1969/1970	2,718	
1970/1971	3,340	22.88
1971/1972	3,672	9.94
1972/1973	4,564	24.29
1973/1974	6,753	47.96
THE 2nd FIVE YEAR DEVELOPMENT PLAN		
1974/1975	10,708	58.57
1975/1976	12,643	18.07
1976/1977	15,467	22.34
1977/1978	19,011	22.91
1978/1979	22,746	19.65
THE 3rd FIVE YEAR DEVELOPMENT PLAN		
1979/1980	32,025	40.79
1980/1981	45,446	41.91
1981/1982	58,127	27.90
1982/1983	62,476	7.48
1983/1984	77,623	24.24
THE 4th FIVE YEAR DEVELOPMENT PLAN		
1984/1985	89,885	15.80
1985/1986	96,997	7.91
1986/1987	102,683	5.86
1987/1988	124,817	21.56
1988/1989	142,105	13.85
THE 5th FIVE YEAR DEVELOPMENT PLAN		
1989/1990	167,185	17.65
1990/1991	195,597	16.99
1991/1992	227,450	16.29
1992/1993	259,884	14.26
1993/1994	329,776	26.89
THE 6th FIVE YEAR DEVELOPMENT PLAN		
1994/1995	379,212	14.99
1995/1996	445,401	17.45

*) GDP growth rate without indexing

Source: Nota Keuangan (The Government's Yearly Notification Budget), 1969/1970 - 1995/1996. 0

Figure 1.4 The Indonesian Growth of Consumption 1969-1994



Source: International Financial Statistics Yearbook 1996.

Table 1.9 Approved Forign and domestic Direct Investments in Manufacturing 1993-95

Items	Investment (US$bill.)		Total Number of Projects		Number of Invest. Oriented Projects		Exports (US$bill.)	
	Foreign	*Domestic*	*Foreign*	*Domestic*	*Foreign*	*Domestic*	*Foreign*	*Domestic*
Food	2.0	8.4	71	137	51	100	1.2	2.4
Textiles	1.1	12.4	91	120	85	107	1.9	5.5
Wood	0.3	3.8	44	67	42	65	0.4	1.8
Paper	6.1	8.2	33	66	27	39	2.3	1.6
Pharmaceuticals	0.9	0.6	1	10	0	2	0.0	0.0
Chemicals	2.5	15.7	173	231	143	171	15.1	2.4
Non Metallurgic Mineral	0.9	18.8	38	85	29	63	0.3	2.0
Basic Metals	2.5	2.4	40	26	34	17	0.8	0.5
Metal Goods	3.8	4.0	238	145	197	79	4.7	1.0
Other	0.1	0.2	24	9	23	7	0.2	0.3

Source: BKPM (Investment Coordinating Board) 1990 - 1995 .

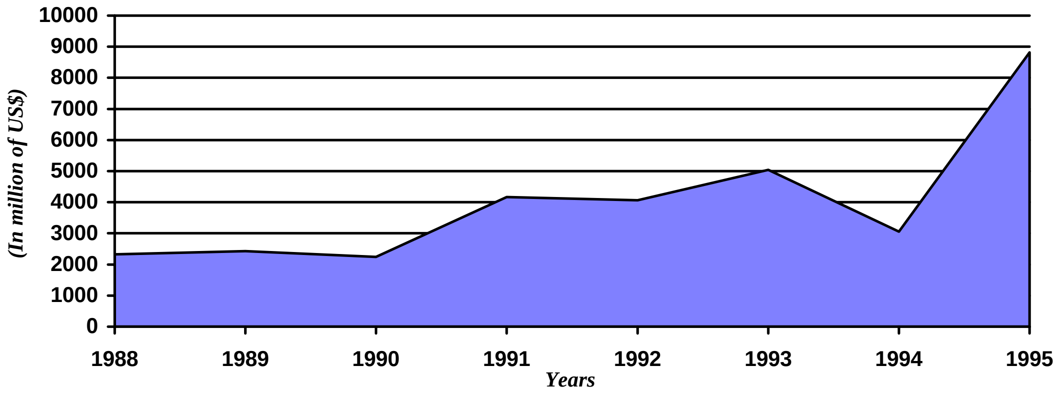
By looking at the composition of investment by sector, during the period of 1993 and 1995, textile, chemicals, and non-metallurgic mineral sectors dominated the market. Investment in chemical and non-metallurgic mineral sectors replaced the domination of woods and metal goods sectors during the period of 1990 and 1992.

As to the capital stock in Indonesia, recently, aggregate capital stock, as a reflection of corporate performance, has tended to increase rapidly. Aggregate capital stock in 1995 is almost four times as that in 1988.

B.4 Money Supply

Money supply in Indonesia is influenced by the country's monetary system. The monetary system in Indonesia consists of several institutions, which can create currency, demand deposits, and quasi money. Those institutions are the central bank and deposit money banks. Before the announcement of the 1992 Banking Act, deposit money banks consisted of commercial banks, development banks, regional development banks, and saving banks. After the Act was enacted, a commercial bank became an institution called a deposit money bank. Bank Indonesia as the Indonesian central bank is the monetary authority. The main role of Bank Indonesia is to control the money supply in the country by using the traditional central bank instruments such as the discount rate and open market operations. As the institution to implement open market operations, Bank Indonesia developed two kinds of monetary instruments: Bank Indonesia certificate (SBI) and money market securities (SBPU). Furthermore, Bank Indonesia also provides the discount window facility as one of indirect monetary instruments. There are two types of discount windows, namely, Discount Window I and Discount Window II. The former was designed to provide funds for daily liquidity management, and also to perform as an indirect monetary instrument. The latter was designed as a tool encouraging banks to provide term loans. Since the beginning of 1st Five Year Development Plan, both of M1 and M2 increased rapidly along with the growth of GDP. The ratio of M1 to GDP and M2 to GDP reached 70 % for the former and 140 % for the latter. This phenomenon was caused by the financial reform during the 1980s. However, after the enactment of a series of financial deregulations in 1988, the government faced another problem, which was an overheating of economy. During the period when the economy overheated and cooled down thereafter, supply of M1 increased by 31.7 % and 34.7 % for M2 in 1989. The result was an increase in inflation rate, from 5.47 % in 1988 to 5.97 % in 1989. To address the problem, the government launched a tight monetary policy, which consisted of the open market operation of selling SBI. Bank Indonesia also increased the SBI's discount rate; the rate on 7-day SBI increased from 10 % at the end of April 1990 to 16.25 % in October 1990. The result of tight monetary policy was a

Figure 1.5 The Indonesian Aggregate of Capital Stock 1988-1995



Source: International Monetary Fund, Balance of Payment Statistics Yearbook 1996.

Table 1.10 The Monetary Condition during Overheated and Cooling down period

(%)

Year	Credit	M1 (Narrow Money)	M2 (Broad Money)	Inflation	GDP
1988	33.9	13.5	23.9	5.47	5.8
1989	44.6	39.8	39.8	5.97	7.5
1990	53.6	18.4	44.2	9.53	7.2
1991	16.3	10.6	17.0	9.52	6.9
1992	8.9	9.3	20.2	4.94	6.4
1993	19.9	28.7	22.3	9.77	6.7

Source: Bank Indonesia, Indonesian Financial Statistics and Weekly Reports.

decline in the growth of M1 from 18.4 % in 1990 to 10.6 % in 1991, and also a decline in the growth of M2 from 44.2 % in 1990 to 17.1 % in 1991 (Table 1.10).

1.2.2 Fiscal Position

A.1 Government Expenditure

The Indonesian government budget expenditures is financed by tax revenue, government savings, and foreign aid. At the beginning of 1st Five Year Development Plans, foreign aid was the biggest source of finance but the government's saving took over this position at the oil boom period in 1973. However, foreign aid returned again as the main source of finance in the period between 1986 and 1991 (Table 1.11). Fluctuation of the government expenditures depends on several factors such as fluctuation of its revenue, the rate of inflation, and the debt service ratio.

Looking at the government routine expenditure by component (for the 1996/1997 state budget and the 1997/1998 proposed state budget), the largest contribution is the foreign debt payment and the second largest is personnel expenditures. Also, among other expenditure items, development expenditure is quite large.

Compared with the previous year's budget, the total budget for the 1997/1998 fiscal year will be greater by 11.6 %. When the new budget is adjusted for future expected inflation, the difference will be only five %. The total budget for the 1997/1998 fiscal year is Rp.101.08 trillion (US$42.8 billion).

The proposed budget includes Rp.62.15 trillion of routine expenditures and Rp.38.92 trillion of development expenditures. The development expenditures are 12.8 % higher than that of the previous year due to the government's supports for the poverty alleviation program.

Most development expenditures are allocated to regional development. In order to reduce the welfare gap between the west and the east, the government has adopted a special development program, which is applied to the eleven areas of economic growth in east Indonesia.

Stated in the budget proposal is that high economic growth under pinned by solid and dynamic monetary stability will promote a more equal distribution of the fruits of development. By evaluating the previous budget, the government successfully cut the number of people in absolute poverty from 26 million in 1993 to 22 million in 1996.

As to the revenue side, the government expected to receive Rp.64 trillion as tax revenue in 1997/1998, 16 % more than previous year. The government also expected an increase in revenue from domestic sources to Rp.88.06 trillion, 87 % of the total revenue, and the remaining 13 % from foreign loans.

Income tax was expected to hold the largest share of the state's tax (23 % of total tax

Table 1.11 Budget Expenditures Financing Sources

(billions of Rp.)

Fiscal Year	Budget Expenditures	%	Sources			
			Government's Savings	%	Foreign Aid	%
(1)	(2)	(3)	(4)	(5)=(4):(2)	(6)	(7)=(6):(2)
The 1st Five Year Development Plan						
1969/1970	118.2	100.0	27.2	23.0	91.0	77.0
1970/1971	176.8	100.0	56.4	31.9	120.4	68.1
1971/1972	214.4	100.0	78.9	36.8	135.5	63.2
1972/1973	310.3	100.0	152.5	49.1	157.8	50.9
1973/1974	458.3	100.0	254.4	55.5	203.9	44.5
The 2nd Five Year Development Plan						
1974/1975	969.6	100.0	737.6	76.1	232.0	23.9
1975/1976	1,400.9	100.0	909.3	64.9	491.6	35.1
1976/1977	2,060.0	100.0	1,276.2	62.0	783.8	38.0
1977/1978	2,159.9	100.0	1,386.5	64.2	773.4	35.8
1978/1979	2,557.9	100.0	1,522.4	59.5	1,035.5	40.5
The 3rd Five Year Development Plan						
1979/1980	4,016.1	100.0	2,635.0	65.6	1,381.1	34.4
1980/1981	5,920.8	100.0	4,427.0	74.8	1,493.8	25.2
1981/1982	6,944.0	100.0	5,235.0	75.4	1,709.0	24.6
1982/1983	7,362.0	100.0	5,422.0	73.6	1,940.0	26.4
1983/1984	9,903.3	100.0	6,020.9	60.8	3,882.4	39.2
The 4th Five Year Development Plan						
1984/1985	9,954.5	100.0	6,476.5	65.1	3,478.0	34.9
1985/1986	10,873.9	100.0	7,301.3	67.1	3,572.6	32.9
1986/1987	8,333.5	100.0	2,581.3	31.0	5,752.2	69.0
1987/1988	9,479.8	100.0	3,321.8	35.0	6,158.0	65.0
1988/1989	12,256.0	100.0	2,265.3	18.5	9,990.7	81.5
The 5th Five Year Development Plan						
1989/1990	13,838.0	100.0	4,408.7	31.9	9,429.3	68.1
1990/1991	19,453.3	100.0	9,548.7	49.1	9,904.6	50.9
1991/1992	21,766.3	100.0	11,357.2	52.2	10,409.1	47.8
1992/1993	24,137.0	100.0	13,421.3	55.6	10,715.7	44.4
1993/1994	25,661.1	100.0	15,289.2	59.6	10,371.9	40.4
The 6th Five Year Development Plan						
1994/1995	18,764.1	100.0	16,544.8	88.2	301.9	1.6
1995/1996	20,520.0	100.0	18,350.0	89.4	510.0	2.5
1996/1997	23,708.0	100.0	21,788.4	91.9	569.8	2.4

Source: Nota Keuangan (The Government's Yearly Notification Budget), 1969/1970 - 1996/1997.

revenues), the value added tax and tax on luxury goods the second largest, followed by land and building tax and other taxes.

It was stated in the 1997/1998-budget proposal that the government expects an increase in expenditure of the 1997/1998-budget proposal, especially an increase in salaries and wages expenditure. The salaries and wages are expected to increase to Rp.32 trillion (US$14.3 billion), 16 % higher than that of the previous fiscal year.

A.2 Public Borrowing

Although the percentage of aids as a share of government revenue decreased recently, many foreign institutions suggested the government should not rely on aids altogether, and rely on domestic sources for sustaining its development programs. The percentage share of aids to the government’s domestic revenue decreased from 37.3 % in the 1969/1970 fiscal year to 15.9 % during the 1996/1997 fiscal year (Table 1.13).

A.3 Aggregate Tax Revenue

Since the reform in 1983, the government revenue from taxes have become more important as a main source in funding budget expenditures. The structural change in the government's revenue was caused not only by the decline in international oil market prices but also by the serial financial reform, such as tax reforms in 1983, launched by the government in anticipation of the Dutch Disease.

The domination of revenues from the oil and gas sectors in the total government revenue in the starting year of the 1st Five Year Development Plan was replaced by revenue from taxes in the 1989/1990 fiscal year, although oil and gas revenues recovered the first position the following year. Since the 1991/1992 fiscal year, the oil and gas revenue has not exceeded the revenue from taxes, and the gap has widened. Recently, the revenue from taxes reached three times as much as that from the oil and gas sectors (Table 1.14).

Comparing the 1996/1997 budget with the 1997/1998 budget proposal, the 1997/1998 total revenue is expected to increase by 11.5 % from the previous budget revenue (from Rp.90,616.4 billions to Rp.101,056.7 billions). Income is expected to increase by 22.8 % (from Rp.23,708 billions to Rp.24,601.4 billions). The Value Added Tax and Sales Tax on luxury goods is expected increase by 12.9 % from Rp.21,788.4 billions to Rp.24,601.4 billions, the Land and Building Tax by 10 % from Rp.2,277.3 billions to Rp.2,505 billions, and finally, the Other Tax by 11 % from Rp.569.8 billion to Rp.632.5 billions (Table 1.15).

Looking at the composition of tax revenue, the revenue from VAT exceeded that from Income

Tax in the period of 1985 to 1991. But it dropped afterwords, the reason for this drop in VAT revenue was a decline in commodity prices in both domestic and overseas markets. The other reason was due to various VAT exemptions especially that for export-oriented products (Table 1.15).

1.3 Tax Structure: Institution and The Reality

Since 1983, Indonesia has revised the tax law twice. The purpose of such revisions are to raise the government revenue from taxes to induce more investment from both domestic and abroad, to bring equality among those subject to taxation both horizontally and vertically, and to avoid double taxation.

1.3.1 The Reforms

The government implemented significant reforms in its tax system in 1983 and 1984. The general framework was introduced in 1983 under the Amendment of Law Number 6, Year 1983.

For the direct tax, the new income tax law mended the personal and corporate income tax structures. These tax changes enhanced the equity, revenue productivity, and efficiency of income tax. Under the new income tax law, certain deductions, such as, premiums for life and health insurance (unless paid by employers), gifts, personal expenses, and contributions were cut. Another direct tax, the land and building tax replaced regulations made by the Dutch colonial government. The direct tax encouraged improving productivity, along with pursuing economic growth. For the indirect tax, the old sales tax system was replaced by the value added tax system (VAT) in 1984. The VAT system corrected the weaknesses of the former sales tax. By broadening the tax base, VAT was expected to generate stable revenue. Another indirect tax law was a stamp duty law implemented in 1984.

1.3.2 The Revisions

At the end of 1994, the government announced the revisions of the 1983 income tax law, the 1984 VAT and sales tax on luxury goods law, and the 1984 land and building tax law. The reasons for the revisions were to intensify tax collection, to increase the number of tax payers, to close loopholes caused by the ambiguity of some articles in the tax laws, and to restructure the tax bracket in order to increase capital inflow.

The Parliament passed the new tax law in October 1994 with effect from January 1, 1995. The main features were as follows:

Table 1.12 State Budget (APBN) 1996/1997 and Proposed State Budget (RAPBN) 1997/1998

(in billions rupiah)

Revenue Items	APBN 1996/1997	RAPBN 1997/1998	%⊇	Expenditure Items	APBN 1996/1997	RAPBN 1997/1998	%⊇
A. Domestic Revenues	78,202.8	88,060.7	12.6	A. Routine Expenditures	56,113.7	62,158.8	10.8
				I. Personnel Expenditures	18,280.6	21,192.0	15.9
I. Oil/Gas	14,120.1	14,871.1	5.3	1. Salaries/Pensions	14,763.0	17,048.4	15.5
1. Oil	10,315.6	10,688.2	3.6	2. Rice Allowance	1,193.7	1,309.5	9.7
2. Gas	3,804.5	4,182.9	9.9	3. Food Allowance	1,121.5	1,233.7	10.0
				4. Other Domestic Personnel	710.3	1,009.9	42.2
				5. Overseas Personnel	492.1	590.5	20.0
II. Non-Oil/Gas	64,082.7	73,189.6	14.2	II. Material Expenditures	6,589.0	8,895.2	35.0
1. Income Tax	23,708.0	29,117.7	22.8	1. Domestic	6,257.5	8,478.0	35.5
2. VAT & Sales Tax on Luxu-rious goods	21,788.4	24,601.4	12.9	2. External	331.5	417.2	25.9
3. Import Duties	3,450.5	3,324.7	-3.7	III. Subsidies to Local Government	10,012.3	11,535.8	15.2
4. Excise Duties	4,033.0	4,436.3	10.0	1.Personnel Expenditures	9,495.9	10,967.8	15.5
5. Export Tax	160.1	100.0	-37.5	2.Non-Personnel Expenditures	516.4	568.0	10.0
6. Land and Building Tax	2,277.3	2,505.0	10.0	IV. Debt Amortization & Interest Payment	20,226.8	19,570.9	-3.2
7. Other Tax	569.8	632.5	11.0	1. Domestic debt	290.6	334.2	15.0
8. Non-tax Revenues	7,267.8	8,225.8	13.2	2. Foreign debt	19,936.2	19,236.7	-3.5
9.BBM receipts *)	827.8	249.2	-69.9	V. Other	1,005.0	964.9	-4.0
B. Development Revenues	12,413.6	13,026.0	4.9	B. Development Expenditures	34,502.7	38,927.9	12.8
I. Program Aids	-	-	-	I.Rupiah Expenditures	22,089.1	25,901.9	17.3
II. Project Aid	12,413.6	13,026.0	4.9	II. Project Aid	12,413.6	13,026.0	4.9
TOTAL	90,616.4	101,056.7	11.6	TOTAL	90,616.4	101.086,7	11.6

*) Central Government share from domestic sales of fuels (e.g. petrol, kerosene, gas, etc.)

Source: Nota Keuangan (The Government's Yearly Notification Budget) 1996/1997.

Table 1.13 The Percentage of foreign Aid to Domestic Revenue

(in billion Rupiah)

FISCAL YEAR	FOREIGN AID	DOMESTIC REVENUE	%
(1)	(2)	(3)	(4)
The 1st Five Year Development Plan			
1969/1970	91.0	243.7	37.3
1970/1971	120.4	344.6	34.9
1971/1972	135.5	428.0	31.7
1972/1973	157.8	590.6	26.7
1973/1974	203.9	967.7	21.1
The 2nd Five Year Development Plan			
1974/1975	232.0	1,753.7	13.2
1975/1976	491.6	2,241.9	21.9
1976/1977	783.8	2,906.0	27.0
1977/1978	773.4	3,535.4	21.9
1978/1979	1,035.5	4,266.1	24.3
The 3rd Five Year Development Plan			
1979/1980	1,381.1	6,696.8	20.6
1980/1981	1,493.8	10,227.0	14.6
1981/1982	1,709.0	12,212.6	14.0
1982/1983	1,940.0	12,418.3	15.6
1983/1984	3,882.4	14,432.7	26.9
The 4th Five Year Development Plan			
1984/1985	3,478.0	15,905.5	21.9
1985/1986	3,572.6	19,252.8	18.6
1986/1987	5,752.2	16,140.6	35.6
1987/1988	6,158.0	20,803.3	29.6
1988/1989	9,990.7	23,004.3	43.4
The 5th Five Year Development Plan			
1989/1990	9,429.3	28,739.8	32.8
1990/1991	9,904.6	39,546.4	25.0
1991/1992	10,409.1	41,584.8	25.0
1992/1993	10,715.7	47,452.5	22.6
1993/1994	10,371.9	52,279.8	19.8
The 6th Five Year Development Plan			
1994/1995	9,837.8	66,418.0	14.8
1995/1996	11,170.0	71,557.8	15.6
1996/1997	12,413.6	78,202.8	15.9

Source: Nota Keuangan (The Government's Yearly Notification Budget), 1969/1970 - 1996/1997.

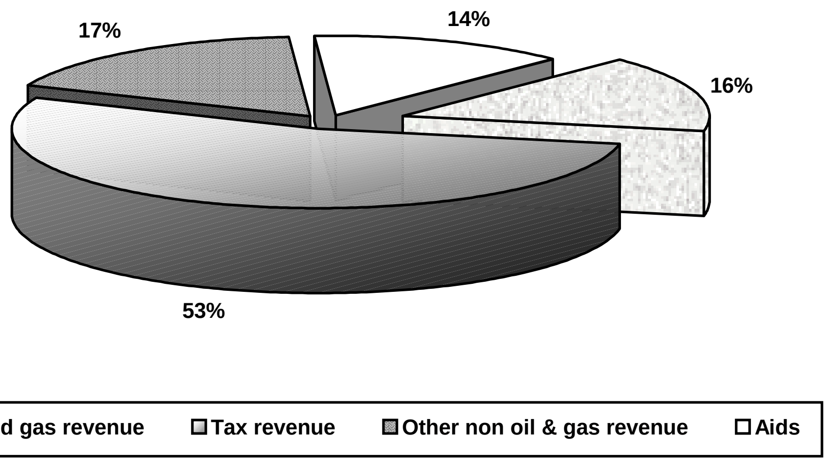
Table 1.14 The Percentage of Tax Revenue to Oil and Gas Revenue

(in billion Rupiah)

FISCAL YEAR	OIL & GAS REVENUE	TAX REVENUE	%
The 1st Five Year Development Plan			
1969/1970	65.8	77.6	117.9
1970/1971	99.2	97.7	98.5
1971/1972	140.7	121.9	86.6
1972/1973	230.5	172.3	74.8
1973/1974	382.2	277.2	72.5
The 2nd Five Year Development Plan			
1974/1975	957.2	424.6	44.4
1975/1976	1,248.0	550.6	44.1
1976/1977	1,635.3	702.4	43.0
1977/1978	1,948.7	893.1	45.8
1978/1979	2,308.7	1,051.6	45.5
The 3rd Five Year Development Plan			
1979/1980	4,259.6	1,217.7	28.6
1980/1981	7,019.6	1,700.8	24.2
1981/1982	8,627.8	2,039.5	23.6
1982/1983	8,170.4	2,587.8	31.7
1983/1984	9,520.2	2,959.3	31.1
The 4th Five Year Development Plan			
1984/1985	10,429.9	3,294.6	31.6
1985/1986	11,144.4	5,015.4	45.0
1986/1987	6,337.6	5,551.0	87.6
1987/1988	10,047.2	6,551.8	65.2
1988/1989	9,527.0	9,171.0	96.3
The 5th Five Year Development Plan			
1989/1990	11,252.1	12,190.3	108.3
1990/1991	17,711.9	15,272.5	86.2
1991/1992	15,039.1	19,683.7	130.9
1992/1993	15,330.4	24,087.5	157.1
1993/1994	12,507.7	29,375.0	234.9
The 6th Five Year Development Plan			
1994/1995	13,537.4	37,258.1	275.2
1995/1996	14,848.7	41,304.0	278.2
1996/1997	14,120.1	48,343.5	342.4

Source: Nota Keuangan (The Government's Yearly Notification Budget),1969/1970 - 1996/1997.

Figure 1.6 The Structure of Government Revenue in the 1996/1996 State Budget



Source: Nota Keuangan (The Government's Yearly Notification Budget) 1996/1997.

Table 1.15 The Growth of Tax Revenue Components

(billion Rp.)

Fiscal Year	Income Tax	%	VAT	%	Stamp Duty	%	Land & Build. tax	%	Total	%
The 1st Five Year Development Plan										
1969/1970	43.0		31.0		3.5		0.1		77.6	
1970/1971	52.7	22.6	40.4	30.3	4.5	28.6	0.1	0.0	97.7	25.9
1971/1972	68.0	29.0	46.4	14.9	7.3	62.2	0.2	100.0	121.9	24.8
1972/1973	87.9	29.3	62.3	34.3	6.7	-8.2	15.4	7,600.0	172.3	41.3
1973/1974	140.3	59.6	105.3	69.0	11.6	73.1	20.0	29.9	277.2	60.9
The 2nd Five Year Development Plan										
1974/1975	225.8	60.9	153.8	46.1	16.5	42.2	28.5	42.5	424.6	53.2
1975/1976	305.9	35.5	191.7	24.6	17.1	3.6	35.9	26.0	550.6	29.7
1976/1977	381.9	24.8	264.5	38.0	11.7	-31.6	44.3	23.4	702.4	27.6
1977/1978	503.8	31.9	318.0	20.2	15.7	34.2	55.6	25.5	893.1	27.1
1978/1979	617.2	22.5	346.6	9.0	19.8	26.1	68.0	22.3	1,051.6	17.7
The 3rd Five Year Development Plan										
1979/1980	792.5	28.4	329.4	-5.0	21.2	7.1	74.6	9.7	1,217.7	15.8
1980/1981	1,112.2	40.3	460.7	39.9	36.0	69.8	91.9	23.2	1,700.8	39.7
1981/1982	1,367.1	22.9	533.9	15.9	38.2	6.1	100.3	9.1	2,039.5	19.9
1982/1983	1,706.5	24.8	707.6	32.5	61.2	60.2	112.5	12.2	2,587.8	26.9
1983/1984	1,932.3	13.2	830.6	17.4	51.5	-15.8	144.9	28.8	2,959.3	14.4
The 4th Five Year Development Plan										
1984/1985	2,121.0	9.8	878.0	5.7	115.0	123.3	180.6	24.6	3,294.6	11.3
1985/1986	2,313.0	9.1	2,326.7	165.0	151.2	31.5	224.5	24.3	5,015.4	52.2
1986/1987	2,270.5	-1.8	2,900.1	24.6	190.4	25.9	190.0	-15.4	5,551.0	10.7
1987/1988	2,663.4	17.3	3,390.4	16.9	222.9	17.1	275.1	44.8	6,551.8	18.0
1988/1989	3,949.4	48.3	4,505.3	32.9	292.1	31.0	424.2	54.2	9,171.0	40.0
The 5th Five Year Development Plan										
1989/1990	5,487.7	39.0	5,836.7	29.6	275.5	-5.7	590.4	39.2	12,190.3	32.9
1990/1991	6,755.3	23.1	7,462.7	27.9	243.5	-11.6	811.0	37.4	15,272.5	25.3
1991/1992	9,580.4	41.8	8,926.1	19.6	302.6	24.3	874.6	7.8	19,683.7	28.9
1992/1993	11,912.6	24.3	10,714.4	20.0	359.9	18.9	1,100.6	25.8	24,087.5	22.4
1993/1994	15,273.1	28.2	12,282.3	14.6	285.3	-20.7	1,534.3	39.4	29,375.0	22.0
The 6th Five Year Development Plan										
1994/1995	18,764.1	22.9	16,544.8	34.7	301.9	5.8	1,647.3	7.4	37,258.1	26.8
1995/1996	20,520.0	9.4	18,350.0	10.9	510.0	68.9	1,924.0	16.8	41,304.0	10.9
1996/1997	23,708.0	15.5	21,788.4	18.7	569.8	11.7	2,277.3	18.4	48,343.5	17.0

Source: Nota Keuangan (The Government's Yearly Notification Budget), 1969/1970 - 1996/1997.

a) Basic deductions were approximately doubled and direct tax rates were cut by roughly one-third.
b) Relatively restrictive tax incentives were introduced for certain investments in export activities or remote regions (such as eastern Indonesia), and tax deductions were allowed for expenditures on training, R&D, and environmental protection.
c) The tax base was widened. For instance, imposing a 15% tax on off-shore deposits placed through Indonesian or foreign banks operating in Indonesia, levying a 5% capital gains tax on certain land transactions, and imposing a 0.1% tax on the sale of shares and other certificates in stock market transactions (founder shareholders of listed companies are subject to an additional 5% tax).
d) The luxury tax was imposed on the selling price of luxury residences (excluding land) at 10 to 50 % tax rates.
e) A property tax exemption (formerly of Rp.7 millions, and applicable only to buildings) was raised to Rp.8 million, but coverage was widened to both buildings and land.
f) Important administrative steps were taken to increase compliance. For example, fines were increased for non/late-filing of VAT and direct tax returns, and certain Tax Regulations were replaced by MOF Decrees, which broadened the tax authority's power to audit for compliance, and not just for assessment. Also, a new Tax Court was established, and there is no right appeal to the Administrative Court.

1.3.3 General Tax Provision and Procedures

A. Registration

Every taxpayer shall be obligated to register himself/itself to the office of the Directorate General of Taxation in the operational area of which he/it resides/domiciled, and shall be granted a taxpayer code/identification number. Furthermore, every businessman/company subject to tax on the basis of the Value Added Tax Law of 1984 shall be obligated to report his/its business to the office of the Directorate General of Taxation in the operational area of which he/it resides/domiciled, and the place business activities, for confirmation as a taxable businessman/company, and shall be granted the taxable company confirmation number. However, many potential taxpayers are still unregistered. Statistics show that the number of individual tax payers are not more than 1 million out of 200 millions of registered residents, although those who have income under certain level, or are subjected to the withholding income tax (limited to one employer), are not required to register.

B. Filing

Every taxpayer shall be obligated to fill out a tax return, sign it, and deliver it to the tax offices of the tax payer's domicile, or other place determined by the Director General of Taxation.

The time limit for submitting the tax return should be:

a) maximum of twenty days after the end of the tax period for tax payers who are subjected to VAT and sales tax on luxury goods.

b) maximum of three months after the end of the tax year for tax payers who are subjected to income tax and withholding tax.

If the tax return is not filled or not submitted in time as mention above, an administrative fine would apply to the periodic tax return at Rp.25,000 and to the annual tax return at Rp.50,000.

C. Administrative penalties

If, concluded that tax dues are unpaid or underpaid based on tax audits or other information, the payer shall be subject to penalties of 2% additional payment to tax amount plus the differences of tax on payments for tax underpaid, and 2% additional payment to tax amount plus the actual amount of tax payments for tax unpaid. The total tax in the assessment of tax underpayment as mentioned above increases by an administrative surcharge at the rates of:

a) 50% of the income tax unpaid or underpaid within one fiscal year;

b) 100% of the income tax not withheld or under withheld, not collected or under collected, not deposited or under deposited, and withheld or collected but not deposited or under deposited.

c) 100% of the value added tax on foods and services and the sales tax on luxury goods unpaid or underpaid.

Many notifications of penalty are issued in a certain period of year. Tax payers, especially withholders who have already withheld or collected, sometimes refuse to proceed the payments to banks or post offices under the central bank's account.

D. Liens and Objections

The government has a lien for tax arrears on the goods owned by the taxpayer/representative. The lien covers the principal amount of tax, interests, administrative fines, surcharges, and collection fees. The lien for tax collection has priority over all other liens, except for:

a) case trial fees which are solely caused by the sanction to auction certain movable or immovable goods;

b) costs already spent on the safeguarding of certain goods;

c) case trial fees which are solely due to the auction and settlement of certain estate.

The lien expires two years after the date of issuance of the tax collection notice, the assessment of tax underpayment, the additional assessment of tax under-payment, as well as decisions on corrections, decisions on objections and decisions of the court of appeals which increase the amount of tax due, unless within the said period a distress warrant for payment is officially issued, or a postponement of payment is granted. On the other hand, the taxpayer might submit an objection only to the Director General of Taxation concerning:

d) the assessment of tax underpayment;

e) the additional assessment of tax underpayment;

f) the assessment of tax overpayment;

g) the nil tax assessment;

h) withholding or collection by a third party based on tax laws.

The objection can be submitted in written from in the Indonesian language by mentioning the amount of tax due or the amount of tax withheld or collected or the amount of loss according to the calculation of the taxpayer along with clear reasons.

E. Audits

The Director General of Taxation is authorized to conducts audits to ascertain the fulfillment of tax obligations and for other purposes within the framework of implementing tax laws. For the purpose of an audit, the tax official in charge will bring along with him an audit warrant and show it to the taxpayer concerned. The taxpayer subject to an audit shall:

a) show and/or submit books or records, documents serving as the basis of bookkeeping and other papers connected with the income obtained, business operations, and independent work of the taxpayer, or objects which incur tax;

b) grant access to places or rooms deemed necessary and give assistance to ensure a smooth audit;

c) provide information needed.

If, the taxpayer is requested to disclose books, records or documents, and information, and yet the taxpayer is committed to an obligation to maintain secrecy, this obligation will be waived by the audit request as mentioned above.

The number of taxpayers' files, which are subject to audit, are growing faster than the increasing number of auditors. Most audit cases occurs at tax refund claims, data received from the third parties (personal or institutions), and taxpayers' declared of losses.

F. Criminal Investigations

A taxpayer who purposely:

a) Fails to register himself/his organization, or uses the taxpayer code number or the taxable company confirmation number unlawfully;
b) fails to submit the tax return;
c) submits a false or incomplete tax return and/or information;
d) shows a false account books, records, or other documents;
e) fails to maintain bookkeeping or records, fails to show or submit account books, records, or other documents; or
f) fails to pay tax;

thereby inflicting losses on state revenue, then he will be liable to a maximum imprisonment of six years and a maximum fine of four times the amount of tax due which is unpaid or underpaid. The penalty will be doubled if the tax offense is repeated before one-year elapses, starting from the end of the term of imprisonment served. In addition, a taxpayer who attempts to commit crimes of (1)using unlawfully the taxpayer code number or the taxable company confirmation number or (2)submitting a false or incomplete tax return and/or information for the purpose of requesting tax restitution or effecting a tax compensation, will be liable to maximum imprisonment of two years and a maximum fine of four times the amount of restitution requested and/or the compensation effected by the taxpayer.

Directorate General of Taxation has a close relationship with a general attorney and police in conducting criminal investigations. This enables smoother procedures of criminal case which concerns tax avoidance.

1.3.4 Income Tax

A. Objects and Subjects of Income Tax

The tax subjects are:

a) any person or individual; and any undivided estate as a unit, in lieu of individual heirs;
b) any organization, in the form of a limited liability company, a limited partnership, other kinds of limited liability companies, a state owned corporation and regional-administration owned corporation in whatever names and forms, a partnership, an association, a small individual business, a cooperative, a foundation or a body of the kind, an institute, a pension fund, and other forms of business units;

c) any permanent establishment.

The tax subjects are made up of the resident tax subject and the non-resident tax subject. Furthermore, the resident tax subjects are:

a) any individual residing in Indonesia or individual present in Indonesia for more than 183 days in a period of 12 months, or individual present in Indonesia during a tax year and intending to reside in Indonesia;
b) any organization set up or domiciled in Indonesia;
c) any undivided estate as a unit, in lieu of individual heirs.

The non-resident tax subjects are:

a) any individual not residing in Indonesia or individual present in Indonesia for not more than 183 days in a period of 12 months, and any organization not set up nor domiciled in Indonesia which carries out business or operates through a permanent establishment in Indonesia;
b) any individual not residing in Indonesia or individual present in Indonesia for not more than 183 days in a period of 12 months, and any organization not set up nor domiciled in Indonesia which may receive or earn income from Indonesia not by carrying out business or operating through a permanent establishment in Indonesia.

The definition of permanent establishment is an establishment by an individual not residing in Indonesia or individual present in Indonesia for not more than 183 days in a period of 12 months, and any organization not set up nor domiciled in Indonesia, to carry out business or operate in Indonesia, in such forms as:

management office; branch office; representative office; an office building; factory; workshop; mine or quarry of natural resources, or area of drilling operation used for mining exploration; fishing area, livestock breeding area, agricultural area, plantation, or forest area; construction project, installation, or assembly project; the provision of services in whatever forms by an employee or another person, as long as it is done for more than 60 days in a period of 12 months; individual or organization acting as an agent with a dependent position; an agent or employee of an insurance company not set up nor domiciled in Indonesia which receives insurance premiums or insures risks in Indonesia.

Tax object would be income, namely any economic benefit received or earned by the taxpayer from within as well as outside Indonesia, which would be used for consumption or to increase the wealth or the taxpayer concerned, in whatever names and forms.

B. Tax Rates and Exemption

Since the tax reform in 1983, the government reduced the income tax rates, changed the brackets, and increased the income exemption as follows:

<u>The 1983 income tax law</u>:

Taxable Income	**Tax Rates**
Up to Rp.10 million	15%
Above Rp.10 million to Rp.50 million	25%
Above Rp.50 million	35%

An amount of taxable income was exempted up to:

a) Rp960,000.00 for an individual tax payer;
b) an additional amount of as much as Rp480,000.00 for a married taxpayer;
c) an additional of as much as Rp960,000.00 for a wife whose income is consolidated with her husband's income;
d) an additional amount of as much as Rp480,000.00 for each family member by blood and family member by marriage in a straight line as well as any adopted child, who was a full dependent, with a maximum of 3 for each family.

<u>The 1994 income tax law</u>:

Taxable Income	**Tax Rates**
Up to Rp.25 million	10%
Above Rp.25 million to Rp.50 million	15%
Above Rp.50 million	30%

An amount of taxable income is exempted up to:

a) Rp1,728,000.00 for an individual tax payer;
b) an additional amount of as much as Rp864,000.00 for a married taxpayer;
c) an additional amount of as much as Rp1,728,000.00 for a wife whose income is consolidated with her husband's income;
d) an additional amount of as much as Rp864,000.00 for each family member by blood and family member by marriage in a straight line as well as any adopted child, who was a full dependent, with a maximum of 3 for each family.

1.3.5 Value Added Tax and Sales Tax on Luxury Goods

A. Objects and Collectors of Value Added Tax and Sales Tax on Luxury Goods

Value added tax is imposed on:

a) delivery of taxable goods carried out by the company in the customs area;
b) import of taxable goods;

c) delivery of taxable services carried out by the company in the customs area;

d) the utilization of taxable intangible items from non customs areas in the customs area;

e) utilization of taxable services from non customs areas;

f) export of taxable goods by the taxable company.

Sales tax on luxury goods is imposed on:

g) delivery of taxable goods under the luxury category carried out by the company/firm which manufactures the said luxury goods in the customs area in the course of its business or work;

h) import of taxable goods under the luxury category.

Sales tax on luxury goods is imposed only once at the time of delivery of taxable goods under the luxury category by the manufacturing company/firm or at the time of import.

The collectors of value added tax and sales tax on luxury goods are an individual, organization or government agency appointed by the Minister of Finance, remit and report the tax owed by the taxable company on the delivery of taxable goods and/or provision of taxable services to/for the said individual, organization or government agency.

B. Tax Rates and Exemption

The rates of the value added tax as follows:

a) the rate of value added tax is 10%;

b) the rate of value added tax on export goods is 0%;

c) by a government regulation, the tax rate for above mentioned character (a) can be changed at minimum of 5% and at maximum of 15%.

The rates for sales tax on Luxury goods as follows:

a) the rate of sales tax on luxury goods is fixed at the minimum of 10% and at maximum of 50%;

b) the export of taxable goods under the luxury category is subject to the rate of 0%.

1.3.6 Land and Building Tax

A. Objects of Land and Building Tax

Land and Building Tax is imposed on every piece of land and building within the country borders of Indonesia.

B. Tax Rates and Exemption

The taxable objects are taxable at minimum of 20% and at maximum of 100% of the price of land and/or building based on the market value. Furthermore, the land and building tax rate is 0.5% of the taxable objects.

Based on the 1983 land and building tax law, exemption ceiling is as much as an amount of Rp.2 million per object. However, exemption ceiling has increased to Rp.8 million under the 1994 revision of land and building tax.

1.3.7 Tax Treaty

So far the government has signed up to more than 40 treaties with foreign countries, and 32 treaties have been implemented. The reason for arranging such treaties is to avoid double taxation, especially in the correlation of international trade of goods and services. The list of the treaty as follows.

1.3.8 The Additional Tax Laws

Recently, the government announced several tax laws in the Parliament April 10, 1997. The government believed that the laws would strengthen the basic law as the government tools to collect the revenue from tax and duty. Furthermore, some of the new laws replaced the old laws from the Dutch colonial era, which were out of date and became inappropriate according to the recent situation. The new tax laws are as follows.

A. The Law of Tax Lawsuit Accomplishment Board

The new tax law was launched under the amendment of law no. 17/1997 which concerns the law of tax lawsuit accomplishment board. The new law seems like a realization of article no. 27 in law no. 9/1994 concerning general tax provisions and procedures. The law stipulates the form of a board as a highest court in accomplishing any tax lawsuit, from taxpayers against the government, vice versa. The law also regulates the place and function of the board, board members, the rule that apply to any participant in the court, etc.

B. The Law of Regional Tax and Duty Collections

The new tax law was launched under the amendment of law no. 18/1997 concerning the law of regional tax and duty collections. The purpose of this tax law is to avoid overlapping tax

Table 1.16 The List of Tax Treaty Rates between Indonesia and Foreign Countries

No.	Country	Starting Date	Dividend		Interest			Royalty		Rates
			Portfolio Invest.	Direct Invest.	Gene-ral	Special Case	Central Bank	Gene-ral	Special Case	
1.	Australia	01/07/93	15%	15%	10%	-	0%	15%	10%	15%
2.	Austria	01/01/89	15%	10%	10%	-	0%	10%	-	12%
3.	Belgium	01/01/75	15%	15%	15%	10%	0%	10%	-	15%
4.	Bulgaria	01/01/93	15%	15%	10%	-	0%	10%	-	15%
5.	Canada	01/01/80	15%	15%	15%	-	0%	15%	-	15%
6.	Denmark	01/01/87	20%	10%	10%	-	0%	15%	-	15%
7.	Finland	01/01/90	15%	10%	10%	-	0%	15%	10%	15%
8.	France	01/01/81	15%	10%	15%	10%	0%	10%	-	10%
9.	Germany	01/01/92	15%	10%	10%	-	0%	15%	10% or 7.5%	10%
10.	Hungary	01/01/94	15%	15%	15%	-	0%	15%	-	-
11.	India	01/01/88	15%	10%	10%	-	0%	15%	-	10%
12.	Italy	01/01/96	15%	10%	10%	-	0%	15%	10%	12%
13.	Japan	01/01/83	15%	10%	10%	-	0%	10%	-	10%
14.	Luxembourg	01/01/95	15%	10%	10%	-	0%	12.5%	10%	10%
15.	Malaysia	01/01/87	15%	15%	15%	-	0%	15%	-	12.5%
16.	Netherlands	01/01/71	15%	10%	10%	-	0%	20%	10% 5%	9%
	Renegotiation	01/06/94	15%	10%	10%	-	0%	10%	-	9%
17.	New Zealand	01/01/89	15%	15%	10%	-	0%	15%	-	-
18.	Norway	01/01/91	15%	15%	10%	-	0%	15%	10%	15%
19.	Pakistan	01/01/91	15%	10%	15%	-	0%	15%	-	10%
20.	Philippines	01/01/83	20%	15%	15%	10%	0%	15%	-	20%
21.	Poland	01/01/94	15%	10%	10%	-	0%	15%	-	10%
22.	Saudi Arabia*	01/01/89	-	-	-	-	-	-	-	-
23.	Singapore	01/01/92	15%	10%	10%	-	0%	15%	-	15%
24.	South Korea	01/01/90	15%	10%	10%	-	0%	15%	-	10%
25.	Sri Lanka	01/01/95	15%	15%	15%	-	0%	15%	-	20%
26.	Sweden	01/01/90	15%	10%	10%	-	0%	15%	10%	15%
27.	Switzerland	01/01/90	15%	10%	10%	-	0%	12.5%	-	10%
28.	Taiwan	01/01/96	10%	10%	10%	-	0%	10%	-	5%
29.	Thailand	01/01/82	15%	15%	15%	-	0%	15%	10%	20%
30.	Tunisia	01/01/94	12%	12%	12%	-	0%	15%	-	12%
31.	U. K.	01/01/76	15%	10%	10%	-	0%	15%	10%	10%
	Renegotiation	01/01/95	15%	10%	10%	-	0%	15%	10%	10%
32.	USA	01/02/91	15%	15%	15%	-	0%	15%	10%	15%

*)The treaty with Saudi Arabia limited to both of country's airline companies.

Source: Ministry of Finance - Directorate General of Taxation, Directorate of International Tax Affairs 1997.

collection among the central, provincial, and local governments. The taxpayers have suffered double taxation. The new tax law reduces types of taxes, which are collected by the provincial and local government, from around 200 types to 9 types of taxes. On the other hand, the tax law also balances the percentage of tax revenue shared at different levels of the governments (Table 1.17).

C. The Law of Tax Collection with A Distress Warrant

The new tax law was launched under the amendment of law no. 19/1997 concerning the law of tax collection with a distress warrant. The law is like a realization of article no. 21 in law no. 9/1994 on general tax provisions and procedures. An article in the law states that a distress warrant, which is issued by the Ministry of Finance, has a power above the regular court's decree. The distress warrant has a purpose to conduct taxpayer's compliance to fulfil tax due.

D. The Law of Tax on Conversion of Land and Building Ownership

The new tax law was launched under the amendment of law no. 21/1997 concerning the law of tax on conversion of land and building ownership. This tax law is closely related with the land and building tax. Furthermore, the tax law replaces the old one issued by the Dutch colonial government in 1924. An article in the tax law states that the tax exemption is as much as Rp.30 million.

1.4 Country-Specific Fiscal Issues

1.4.1 Recent Economic Condition

The robust growth of economy has continued. The Central Bureau of Statistics estimates the real growth at 8.2% in 1995 and 7.8% in 1996. It is expected to continue at 7.8% in 1997. Inflation declined to 6.6% in 1996 from 9.0% in 1995, and to 5.5% in the first quarter of 1997 which was the lowest level since 1992. The interest rate remained steady during 1996 until the first quarter of 1997. Balance of payment surplus in 1996 disappeared, which had existed for the last two decades. Finally, the negative effects of the overheated economy caused at the beginning of 1997. The term of the overheating economy actually is nothing more than an excess of aggregate demand which resulted in an inflation and an increasing current account deficit (CAD). The CAD was running at a relatively high level at approximately 4% of GDP. The effect of the excess aggregate demand, which exceeded the national production capacity,

Table 1.17 The Vertical Intergovernmental Fiscal Imbalance in Indonesia 1990/1991

(%)

	Revenue Share *)	**Expenditure Share**	**Surplus/Deficit**
Own Source Revenues			
National	96.1	83.1	13.0
Subnational	3.9	16.9	-13.0
Provincial	2.8	9.3	-6.5
Local	1.1	7.6	-6.5
All Levels	100.0	100.0	0.0
Own Source and Shared Revenues			
National	94.3	83.1	11.2
Subnational	5.7	16.9	-11.2
Provincial	3.5	9.3	-5.8
Local	2.2	7.6	-5.4
	Revenue Share *)	**Expenditure Share**	**Surplus/Deficit**
All Levels	100.0	100.0	0.0
Own Source, Shared Revenues and Transfers			
National	82.2	83.1	-0.9
Subnational	17.8	16.9	-0.9
Provincial	9.9	9.3	0.6
Local	7.9	7.6	0.3
All Levels	100.0	100.0	0.0

*) Included development receipts (program aid and project aid).

Source: the World Bank Discussion Papers no.239, the Intergovernmental Fiscal Relations in Indonesia, 1994 based on Ministry of Finance and Central Bureau of Statistics report.

caused diversion in some export commodities in the domestic market. Thus, the lower revenue from exports caused the balance of payment deficit.

The other issue is the political impact to the economy condition. There were many riots during 1996 to the middle of 1997.

a) On July 27 1996 in Jakarta, the riot was the culmination of several months of turmoil within the Indonesian Democratic Party (PDI) leadership. A full-scale riot occurred involving several thousands people and hundreds of police. As a result, several building got burned.
b) On December 24, 1996, approximately 20,000 Timorese at Dili, East Timor, when welcoming the arrival of Bishop Bello, who had received a Nobel Prize Award, were doing destructive actions around the city of Dili. One may analyze that one of many possible reasons was the dissatisfaction of Timorese toward the government's "no appreciating response" to Bishop Bello as a Nobel Prize winner.
c) On December 26-27, 1996, mass violence and riots exploded in Tasikmalaya, West Java. The two days riot was caused by a report that three teachers from an Islamic boarding school were beaten in police custody. The teachers had been summoned for punishing the son of one of the police officers. The student caught stealing at the school. However, the report developed into racist and sectarian sentiments, which stimulated mass violence.
d) On December 30, 1996, another riot took place in Sanggau Ledo, Sambas, in West Kalimantan. The riot was initiated by the physical brutality of a group of Madurese people (originally came from Madura island, East Java) against two native Dayak people who were accused of having harassed a Madurese girl. This developed into massive ethnic conflict between the two ethnic groups.
e) Finally, the riots which occurred during the 1997 general election in the middle of 1997. The riots occurred during a brutal campaign month. One of due reasons was the speculation of the President Suharto's last election period.

Most experts analyze that the riots reflect bad politic and economic conditions generally in Indonesia. People need more freedom of speech, democracy, and the improvement of social environment. Although most of the chaos above had been caused by political reasons, all of the riots, especially July 27's riot had an economic impact. The Jakarta Stock Exchange's composite index started to decline during the first half of 1996. The index declined 20 points from January to the early June following the issue of the President's health. However the market's index stood at 561 on July 26, the day before the riot, and it fell about 20 points to 541 points. In the foreign exchange market, the spot value of rupiah to US$ fell from 2,325 to 2,332 over the next two weeks. The private inter-bank forward market for the rupiah marked a small response to the riot. The three months US$/Rupiah rate minus Singapore Inter Bank Offered Rate (SIBOR) jumped by two points immediately following the riots. Finally, the riot also decreased the capital inflow to Indonesia. The foreign direct investment approval was strong before the riot, however many potential foreign investors cancelled their proposal considering the political risk after the riot.

Recently there have been currency fluctuations in most Southeast Asian countries. The Thailand's baht, the Philippines's peso, the Malaysia's ringgit, and the Indonesia's rupiah depreciated against foreign currencies, especially against the US dollar. Most currencies were devaluated at an average of 30%. The rupiah fell even worse, several weeks after. On August 14th, the government announced that it will stop its intervention in maintaining the value of rupiah. The value of the rupiah have been decided by the market price thereafter. After the announcement, the rupiah value fell down from Rp.2.653 to Rp.2.659 against the US dollar. The next day, the rupiah value fell even further to Rp.2.880 when the government announced the a tightening in its money policy. The rupiah kept falling until August 18th when it reached the lowest value at Rp.3.035 against the US dollar. On September 20, 1997, the government released a presidential decree number 39, which stated a suspension of big projects stemming from economic woes. However, the rupiah value kept falling until the government asked help from the International Monetary Funds (IMF) in October 1997. In following to the IMF's bailout package program, the government liquidated 16 private banks which were mostly owned by the president's family, and toppled the president's son who was the leader of a national car's project. However, there is a tendency in the society to be ignorant of the government's policies, especially among the president's family who are business holders in Indonesia. Some big projects, which had been suspended, are still proceeding. The result, the value of rupiah dropped to the lowest level as much as Rp.8.400 in the first week of 1998.

The depreciation of the rupiah affected other sectors. The stock market suffered the most. The accumulative stock price index touched the lowest point at 590.73 or 20.28% drop from the July 8th level at 740.83. Some businessmen from insurance companies reported that they lost potential clients due to the phenomenon.

1.4.2 The Eastern Indonesia Issue, the search of a solve for welfare inequality

In the 1997/1998 budget, the government decided a special budget for eleven areas in Eastern Indonesia to reduce the welfare gap between the west and the east, because the gap is likely to widen in the future if no efforts are made now. Eastern Indonesia is less developed in terms of output and almost all production factors, although it has vast area and is much richer in natural resources than Western Indonesia. As we can see in Table 1.18, more than 60 % of area is located in Eastern Indonesia. However, most provincial governments are faced with such problems as such as a lack of skilled labor and poor infrastructures that will hinder the sustainability of development.

So far, the share of economic potentials to GDP and investment are very low. Unlike the Western part, work forces in the Eastern Indonesia are allocated to the agricultural sector rather than manufacturing sector.

An observation of the share of regions by industry shows that both agricultural and manufacturing sectors in Eastern Indonesia were less than 20 % compared with those in the Western part (Table 1.19). Almost all indicators of Eastern Indonesia were poorer than those in the Western part such as life expectancy, child mortality, nutritional conditions, and the number of household with electricity. One of the reasons for this disparity is that the government had concentrated only on the western part of Indonesia for a long time. However, the government has recently tried to encourage both domestic and foreign investors to inject their fresh funds in the Eastern Indonesian manufacturing sectors. Although, several critics argue that investments fall short to create spill over effects on local people's welfare, the government has proceeded the development process in the Eastern Indonesia in order to narrow the welfare gap between the two regions.

Based on the government plan in developing Eastern Indonesia, the emphasis on palm oil production has shifted. In year 2000, the government will reduce palm oil plantation in Sumatera (Western Part of Indonesia) from 80 % at the moment, to 48,7 %. Furthermore, there will be many new infrastructures in the Eastern Indonesia in the year 2000. About 16 new pulp industry companies will start operation by year 2005 to 2010. In addition, with new investments, the government will increase cement production capacity from 13.6 %, at the moment, to 21 % by year 2000. Finally, in telecommunication sector, the government will install about 1.3 million telephone lines in the Eastern Indonesia, which increases from 11.5 %, at the moment, to 14.6 % by year 2000.

In addition, the competition of Indonesian products in the world market made the gap wider. Since the government applied some Non Tariff Barriers (NTBs) to the Indonesian commodities due to its commitment as one of the WTO's member, every producer worked hard to reduce its cost of production and increase the quality of the product. The Western Part which had more advanced infrastructures could adjust easier than that on the Eastern Part. By using the Williamson coefficient[2], we can measure the regional inequality that indicate worsening as the number increased from 0.00137 (1986) to 0.00161 (1991) in Figure 1.7.

2 This coefficient is the square root of variance of GRDP/capita weighted by population and divided by total population.

Table 1.18 Distribution of Area in Indonesia

Islands	Area (km^2)	%
Kalimantan	539,460	28.1
Sumatera	473,481	24.7
Irian Jaya	421,981	22.0
Sulawesi	189,216	9.8
Java	132,186	6.9
Other Islands	162,993	8.5
Total	1,919,317	100.0

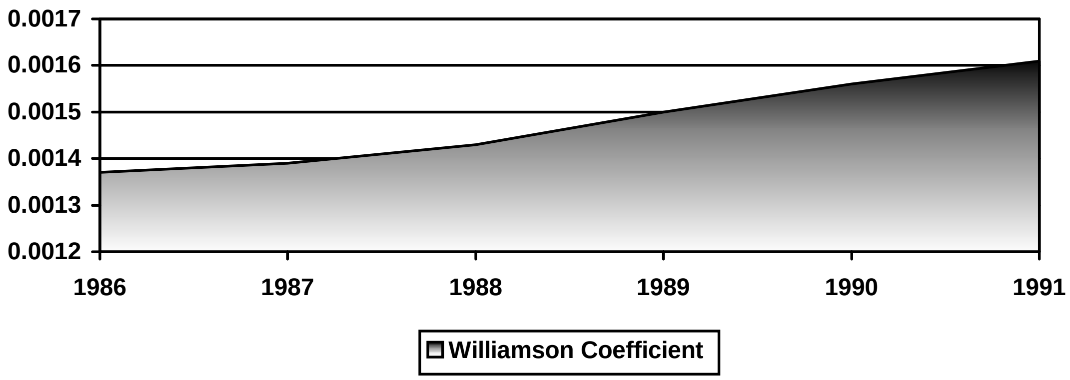
Source: BPS, Central Bureau of Statistics.

Table 1.19 The Agriculture and Manufacturing Share to National GRDP

	Agric.	Small businesses	Large Corporation	Live-stock	Fisheries	Manufacturing	Large & Med. Man.	Small & Home Man.	Non-oil Man.	GRDP
Western Indonesia	84.46	79.47	99.42	84.44	73.56	97.56	97.45	93.34	96.87	92.14
West Nusa Tenggara	1.74	0.89	0.00	2.31	2.00	0.09	0.05	0.57	0.12	0.74
East Nusa Tenggara	1.55	1.14	0.04	3.33	1.53	0.07	0.02	0.49	0.09	0.66
East Timor	0.24	0.34	0.00	0.41	0.05	0.01	0.01	0.06	0.01	0.14
North Sulawesi	1.81	4.19	0.00	1.60	1.88	0.24	0.20	0.99	0.31	0.91
Central Sulawesi	1.26	2.82	0.07	1.24	1.82	0.16	0.11	0.74	0.20	0.54
South Sulawesi	5.45	5.60	0.47	4.69	12.02	1.13	1.17	3.13	1.44	2.59
South East Sulawesi	1.07	2.95	0.00	0.99	1.42	0.05	0.04	0.23	0.07	0.48
Maluku	1.23	2.28	0.00	0.44	2.51	0.59	0.84	0.20	0.75	0.74
Irian Jaya	1.20	0.32	0.00	0.55	3.20	0.11	0.12	0.25	0.14	1.06
Total of the Eastern Indonesia	15.54	20.53	0.58	15.56	26.44	2.44	2.55	6.66	3.13	7.86
All Indonesia	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100.00

Source: BPS, Central Bureau of Statistics, 1994.

Figure 1.7 Trend of Regional Inequality 1986-1991



Source: Herry Darwanto,CSIS, Vol.XXV, No.2, based on Central Bureau of Statistics various editions.

1.5 Conclusion

Despite some success in the Indonesian economic development since the change in political administrators from the old regime at the end of 1960s era, the government still faces several obstacles such as inefficiency, high debt service ratio, and unequally distribution of income, especially between the West and the East. An other challenge is the maintenance of its high economy growth, to compete with other East Asian Newly Industrial Countries.

As an oil producing country, Indonesia has successfully shifted its main revenue source, from the heavily-depended oil revenue to the tax revenue, as domestic revenue generator, and revenue from the export oriented commodities. Thus, Indonesia had successfully escaped from the Dutch Disease, even when the price of oil in the International market fell down.

As a developing country, Indonesia has maintained its economic growth at the level of 8% per annum. The government has given many efforts to build its industries and to keep country's inflation rate at the level of below two digits. However, there will be a decline in the economic growth in 1997 and 1998 due to the recent economic turmoil.

The country still depends heavily on foreign aids and other loans to support its development and its balance of payment deficit. Fortunately, the government has been able to maintain the debt service ratio at a safe level thereby not having to reschedule its debt, maintaining international debtor's confidence.

The government has increased the revenue from tax by implementing the tax reform in 1983. The new tax laws changed the collection system, from official-assessment to self-assessment. Under the self-assessment system, taxpayers count their tax amount and pay in banks or post offices. In addition, the new tax system is more simple and more equal compared to the old system. Since then, the number of taxpayers and the amount of tax revenue increased.

Finally, along its history, Indonesia has had to face many challenges and obstacles instead of enjoying a success story. The political instabilities, mismanagement, externalities, and other destructive factors characterizes its history. For instance, challenges as riots, currency speculators, inequality between regions, and intergovernmental relationship has given many destructive effects to its economy. In addition, there are many other problems to be solved such as unemployment, income disparity, nepotism, collusion, and corruption.

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