# 2. I NDONESIA

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## 2.1 Introduction

The Republic of Indonesia, an archipelago nation in the Indian and Pacific oceans, lies across the equator for one-eighth of the Earth's circumference off the coast of the Southeast Asian mainland. The country is the largest in Southeast Asia, about 752,400 square miles (1,948,700 square kilometres) in area composed of some 13,670 islands, of which more than 7,000 are uninhabited. Indonesia is the most populous nation in Southeast Asia, and it is advantageously located between mainland Asia and Australia.

Indonesia has played a modest role in the world economy since independence, and its importance has been considerably less than its size, resources, and geographic position would seem to warrant. The country is a major exporter of petroleum, natural gas, and tin. In addition, Indonesia is one of the world's main suppliers of rubber and a less significant producer of a wide range of other commodities, such as coffee, tea, tobacco, copra, spices (cloves and nutmeg), and oil-palm products. Nearly all commodity production comes from large estates. Widespread exploration for deposits of oil and other minerals has resulted in a number of large-scale projects that have contributed substantially to general development funds. The projects have, however, tended to reinforce the general position of Indonesia as a supplier of raw materials to world markets.

The corollary of the primary economy is that the country has remained a major importer of manufactured goods and of the technical skills and knowledge required for development. In spite of the substantial domestic market, there has been relatively little industrial development, and the industrial base is somewhat small, mostly concerned with mineral and forestry production and with food processing. Domestic economic resources are limited, and there is a heavy dependence on inflows of foreign aid and private capital to finance large-scale development. Nonetheless, there has been a dramatic increase in the industrial sector that has caused agriculture's contribution to the national income to decline; agriculture, however, still constitutes the largest single element of the economy.

Since the mid-1960s the government has played a crucial role in development, but the private sector has become more influential. The overall goal has been the creation of a mixed economy. A series of five-year plans has emphasized the government's role in developing the economic infrastructure of the country, notably in agriculture, irrigation, transportation, and communications. Thus, the government, together with foreign aid, has remained a major force in projects where private enterprise has not been appearing. These have included the state-owned Oil Company Pertamina, fertilizer production that supports agriculture, and the cement, chemical, paper, and textile-spinning industries. The emphasis in the public sector increasingly has been on independent, self-financing state enterprises. The remainder of major investments in exploration and exploitation of natural resources or in new manufacturing industry has been left to the private sector, subject to overall government supervision and contracts. Defense, though given low priority, has been a substantial drain on the country's resources.

This consistent approach to development has carried its own risks. Its emphasis has been on soundness, and it has been heavily dependent on foreign aid and foreign technical assistance. One problem with such an orthodox emphasis on the role of private enterprise has been that it has led to an increasingly inequitable distribution of income. It has not been possible to implement the policies with sufficient force because powerful military interests and a vast inefficient bureaucracy distort the economic structure.

A major restraint on development has been a swollen and ill-paid bureaucracy. The government's ability to organize and implement development projects has also been limited by lack of experience and the unreliability and inadequacy of statistical and other information. A large inflow of foreign technical assistance has been necessary to help devise economic programs and projects, often as a condition of external capital aid. Low pay and poor working conditions have fostered corruption that has distorted development and imposed a substantial burden.

### 2.2 Overview of Macroeconomic Activity and Fiscal Position

Since July 1997, monetary situation changed dramatically as the rupiah came under pressure. To address this problem, up to August 1997 monetary policy was directed toward tightening domestic liquidity so as to ease the pressure on rupiah. The Government set a sweeping agenda that covers not only macroeconomic stabilization programs through fiscal and monetary policies, but also reform program in the financial and real sectors. The program is technically and financially supported by multilateral agencies such as the International Monetary Fund, the World Bank, and the Asian Development Bank, as well as other bilateral creditors. The internationally supported program was confirmed in the signing of the economic restructuring program in November 1997.

To cope with the worsened crisis, the Government expedited and broadened the coverage of stabilization program and economic reform by the signing of the letter of intent with the IMF on January 15, 1998. In the monetary policy area, the Government strove to regaining confidence in the banking system and stabilizing the rupiah at a level that was compatible with economic fundamentals through tightening economic liquidity.

To restore confidence in the banking system, the Government as of January 27, 1998 has fully guaranteed all depositors and creditors of all locally incorporated banks. The guarantee scheme covers all private-owned commercial banks, joint-venture banks, and state-owned banks. In addition, the Government set up IBRA (Indonesian Bank Restructuring Agency) to strengthen soundness of the banking system, restructure the banking industry, and implements the government guarantee scheme. Besides, to encourage people to put their money back in the national banking system, the Bank of Indonesia’s Certificate (SBI) rates were raised gradually. Its purpose was to make real interest rate positive to attract foreign capital inflow so as to add to the supply of foreign external reserves and strengthen the rupiah exchange rate.

However, further appreciation of the rupiah was hindered by non-economic factors in January and February 1998. Included were discussion on the plan to apply the Currency Board Arrangement (CBA), announcement of private sector domestic debt, issues about the IMF loan package, and political issues with regard to the convening of the People’s Consultative Assembly (MPR). Those non-economic factors so hampered the recovery of confidence of the foreign investors that the high domestic interest rates failed to attract foreign capital as expected.

In addition to regulating many aspects of economic activity, the government plays a direct role in the economy through its implementation of the central government budget. Early each year, the president presents to the House of People's Representatives (DPR) the proposed annual budget prepared by the Ministry of Finance for the upcoming fiscal year. The government maintained its commitment to a balanced central government budget in part by counting foreign borrowing and foreign aid as part of government revenues, labeled as development funds.

The broad outlines of government spending were framed in five-year plans prepared by Bappenas, National Development Agency. The five-year development plan, or Repelita, described overall economic objectives, including the desired growth rates to be achieved in major economic sectors such as agriculture, mining, and industry, and more detailed proposals for selected activities that were of particular concern during the planning period. Repelita V (fiscal years 1989 to 1993) emphasized the objective of continued export diversification and the reduction of foreign aid and foreign borrowing as sources of government revenue. However, the annual central government budget provided a more concrete set of priorities than the broad Repelita guidelines and allowed for adjustments in total spending to meet unforeseen changes in revenue.

Government finance in developing countries is often constrained by the ability to collect taxes; tax collection in these countries is often hindered by the lack of accounting information on many informal businesses, the difficulty in imposing income tax withholdings among the millions of self-employed in agriculture and services, and extensive corruption. Indonesia is no exception to this rule, but during the 1970s the government was able to compensate for the limited domestic tax base by relying on taxes from the formal corporate sector, especially from foreign oil and gas operations. From 1979 to 1983, tax revenues from the oil and gas sector accounted for about 56 percent of total government revenues. Unfortunately, this bountiful resource undermined efforts to address serious problems in domestic tax laws and collection efforts. The prospect of declining oil sector taxes because of the oil market collapse in the mid-1980s, together with a growing recognition of the flaws in domestic tax laws, motivated a comprehensive tax reform in 1980s and in 1994.

The fiscal year 1999/2000 budget (Table I) has been framed at a time of evidence of greater stability in the Indonesian economy coupled with significant improvements in a number of key indicators compared to the drastic levels recorded at one time or another in the course of the past year. The Rupiah/US Dollar exchange rate, for example, which one time in January 1998 hit Rp 17,000/$, has stabilized in earliest months of 1999 at around Rp 8,000-9,000/$; although reaching 77.6 percent for the whole of calendar year 1998, the rate of inflation moderated over the latter part of the year; while central bank's (Bank Indonesia's) benchmark interest rate has been progressively halved from a high of 70% in August 1998 to 35% in December, thereby influencing lower rates throughout the banking sector.

Generally, the aims of the government's credit and fiscal policies have been to provide the conditions for private incentive within the context of financial orthodoxy. Subsidized credit and interest rates, however, have been used in accordance with general government priorities. Consumption and trade credit have been generated largely within the trading system, but there is also a range of private banking and money lending facilities. Apart from these, the private financial sector has been weak and has played only a modest role in mobilizing domestic resources. A strong effort has been made to deregulate the financial system, and foreign investment and aid, subject to development conditions, have been welcomed. The foreign-exchange system in Indonesia has been greatly simplified, and incentives have been provided for foreign investment.

**Table 2.1 State Budget 1998/1999 and 1999/2000**

(billions of rupiah)

| REVENUES | 1998/1999 | 1999/2000 | EXPENDITURES | 1998/1999 | 1999/2000 |
|---|---|---|---|---|---|
| **A. Domestic Revenue** | **149,302.5** | **142,203.8** | **A. Routine Expenditures** | **171,205.1** | **137,155.5** |
| *I. Oil and Gas* | *49,711.4* | *20,965.0* | *I. Personnel Expenditures* | *24,781.4* | *33,569.1* |
| 1. Oil | 32,908.6 | 12,443.4 | 1. Salaries/pension | 19,120.0 | 26,824.9 |
| 2. Gas | 16,802.8 | 8,521.6 | 2. Rice allowances | 1,872.4 | 2,087.1 |
| | | | 3. Food allowances | 1,484.4 | 2,106.9 |
| | | | 4. Other domestic personnel | 1,154.6 | 1,489.9 |
| | | | 5. Overseas personnel | 1,150.0 | 1,060.3 |
| *II. Non-oil and Gas* | *99,591.1* | *121,238.8* | *II. Material Expenditures* | *11,425.1* | *11,039.0* |
| 1. Income tax | 25,846.2 | 40,626.0 | 1. Domestic | 10,059.7 | 10,006.8 |
| 2. Value added tax | 28,940.0 | 34,597.4 | 2. External | 1,365.4 | 1,032.2 |
| 3. Import duties | 5,494.9 | 2,950.3 | | | |
| 4. Excises | 7,775.9 | 10,160.0 | | | |
| 5. Export duties | 942,8 | 2,594.5 | *III. Regional Routine Expenditures* | *13,289.7* | *19,497.6* |
| 6. Land & Building Tax | 3,411.0 | 3,247.0 | 1. Personnel expenditures | 12,606.5 | 18,696.8 |
| 7. Others Tax | 540.0 | 564.5 | 2. Non personnel expenditures | 683.2 | 800.8 |
| 8. Non tax revenue | 26,660.3 | 26,499.1 | | | |
| 9. Oil sales receipts | - | - | *IV. Debt Service Payment* | *66,236.4* | *44,810.9* |
| | | | 1. Domestic Debt | 1,940.1 | 380.1 |
| | | | 2. Foreign Debt | 64,296.3 | 44,430.8 |
| | | | a. Principal | 33,261.5 | 23,904.8 |
| | | | b. Interest | 31,034.8 | 20,526.0 |
| | | | *V. Others* | *55,472.5* | *28,238.9* |
| | | | 1. Oil subsidiaries | 27,534.0 | 9,985.8 |
| | | | 2. Others | 27,938.5 | 18,253.1 |
| **B. Foreign Revenues** | **11,585.6** | **77,400.0** | **B. Development Expenditures** | **92,683.0** | **82,448.3** |
| *I. Program Loan* | *74,044.7* | *47,400.0* | *I. Rupiah Financing* | *52,142.1* | *52,448.3* |
| *II. Project Loan* | *40,540.9* | *30,000.0* | *II. Project Financing* | *40,590..9* | *30,000.0* |
| **TOTAL** | **263,888.1** | **219,603.8** | **TOTAL** | **263,888.1** | **219,603.8** |
| | | | | | |
| Public savings | -21,902.6 | 5,048.3 | | | |
| Surplus/Deficit | 0.0 | 0.0 | | | |

Source: Ministry of Finance (http://www.depkeu.go.jp)

The markets for bonds and commercial paper are also developing, but with little trading in the secondary market. Portfolio investment is regulated by BAPEPAM, the Indonesian Securities and Exchange Commission. In 1987, the market was opened to foreign investors. Two stock exchanges operate in Indonesia, the Jakarta Stock Exchange and the Surabaya Stock Exchange. By 31 October 1996, 262 companies with Rp 307 trillion in assets were listed on these two exchanges.

Rules governing listing, underwriting and trading on the stock exchanges have been liberalized in recent years. For example foreigners may invest directly in shares in the local market. In addition, reforms have been enacted barring insider trading, enabling all shares of public companies not already listed on the stock exchange to be listed without additional formalities and restricting the individual holdings of director of listed companies.

## 2.3 Macroeconomic Activity

A. International Environment

*A.1. Trade Balance*

Indonesia's exports were vital to its economic development, as exports earned the foreign exchange that permitted Indonesia to purchase raw materials and machinery necessary for industrial production and growth. Indonesia strategic development is primarily oriented toward promoting non-oil export, especially manufactured goods, in order to reap the concomitant gains in foreign exchange, job creation and technological development.

**Table 2.2 Foreign Trade of Indonesia 1988 – 1997**

**(Million USD)**

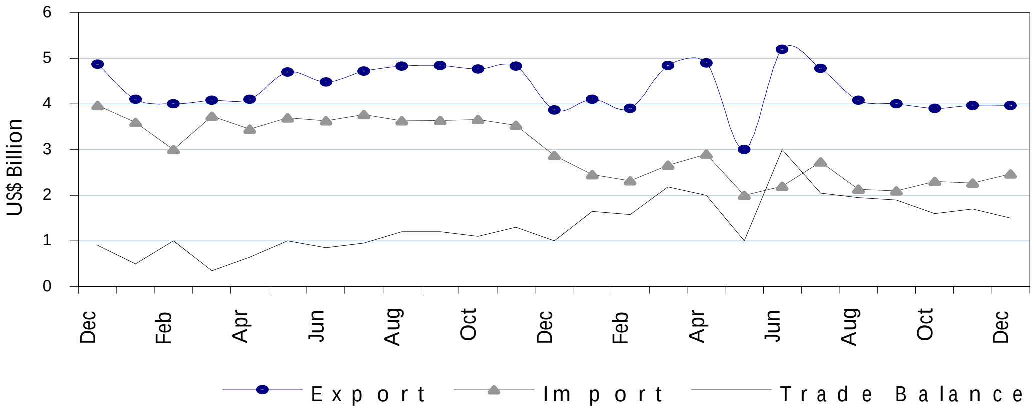
| YEAR | TOTAL | | EXCLUDING OIL AND GAS | |
|---|---|---|---|---|
| | Export | Import | Export | Import |
| 1988 | 19,218.5 | 13,248.5 | 11,536.9 | 12,339.4 |
| 1989 | 22,158.9 | 16,359.6 | 13,480.1 | 15,164.4 |
| 1990 | 25,675.3 | 21,837.1 | 14,604.2 | 19,916.6 |
| 1991 | 29,142.4 | 25,868.8 | 18,247.5 | 23,558.6 |
| 1992 | 33,967.0 | 27,279.6 | 23,296.1 | 25,164.5 |
| 1993 | 36,823.0 | 28,327.8 | 27,077.2 | 26,157.3 |
| 1994 | 40,053.4 | 31,983.5 | 30,359.8 | 29,616.1 |
| 1995 | 45,418.0 | 40,628.7 | 34,953.6 | 37,717.9 |
| 1996 | 49,814.8 | 42,928.5 | 38,092.9 | 39,333.0 |
| 1997 | 53,443.6 | 41,679.8 | 41,821.0 | 37,755.1 |

Source: Central Bureau of Statistics (Badan Pusat Statistik).

Indonesian exports were traditionally based on the country's rich natural resources and agricultural productivity, making the economy vulnerable to the vicissitudes of changing world prices for these types of products. For example, the Dutch colonial economy suffered when world sugar prices collapsed during the Great Depression, and fifty years later, the New Order endured the dramatic oil market collapse in the mid-1980s.

Substantial trade reforms during the 1980s contributed to the surge in manufactured exports from Indonesia. The growth in non-oil exports helped Indonesia maintain a positive trade balance throughout the 1980s in spite of the oil market collapse. However, increases in imports, service costs such as foreign shipping, and interest payments on outstanding foreign debt all contributed to a worsening current account deficit in the late 1980s.

**Figure 2.1 The Indonesian Exports, Imports & Trade Balance (Dec. 1996 – Dec. 1998)**




Source: *Indonesia National Development Information Offices-Monthly Statistical Bulletin*, March 1999

Non-oil/gas export in 1997/98 grew significantly, although at the same time oil/gas export fell steeply. The large decline in oil/gas export value resulted from a drop in both oil prices and export volume. Oil price plunged from $20.7 per barrel to $16.9 per barrel because of weakened demand and increased supply in the international market. The fall in oil demand, as indicated by the lower export value to the United States, Japan, Korea, and Singapore, owed to the economic crisis in Asian countries and the milder winter season in Europe and America compared with that in 1996/1997. On the other hand, the increased supply of oil in the international market was attributed to the agreement set between the United Nations and the Government of Iraq on the oil for food program, quota violation by OPEC member countries, and excessive oil supply from non-OPEC oil-producing countries. To cope with the deteriorating oil price in the future, several countries already agreed to cut down their respective quota. In this regard, Indonesia committed to support OPEC quota reduction from 27.5 million barrels per day to 25.0 million barrels per day.

The exchange rate crisis was responsible for most of the decline in non-oil/gas import. The plunge of rupiah has caused the prices of imported goods more expensive in the domestic markets, compressed consumption and various investment activity, and difficulty in opening L/C with international banks. Meanwhile, the decline in oil/gas was due to the fall of oil price in the international market.

*A.2. Exchange Rate and Exchange System*

Since Indonesia abandoned the multiple exchange rate system in the early 1970s Indonesians have been permitted to convert and move currencies into and out of the country with complete freedom. For many years Indonesia vainly tried to maintain a stable exchange rate by keeping the rupiah tightly pegged to the dollar. The fixed exchange rate only gave the illusion of stability, in fact the rupiah had to be devaluated and always overvalued, then hindered Indonesia's trade.

Then, since the 1986 devaluation, the rupiah has been governed according to a liberal floating system again a basket of currencies. Under this system, the exchange rate was adjusted daily with the rupiah rising or falling against the dollar and other currencies in a away that more accurately reflects the market value of the currency. The Government of Indonesia maintains a freely convertible rupiah under a managed float. The rupiah is traded in an interbank market in Jakarta. Indonesia maintains no capital controls and foreign exchange may flow freely in and out of the country.

*A.3. Balance of Payment*

In 1997/98, Indonesia's balance of payments encountered unprecedented strains emanating from the financial crisis since July 1997. Private sector capital inflows - that remained strong in the first quarter of 1997 - suddenly fell and finally reversed into massive capital outflows. As a result, the capital account that has always been in net surplus since the First Five-year Development Plan converted into a large deficit. The current account indeed improved considerably in the year under review because of a drop in import in response to the exchange rate crisis. Nevertheless, the deficit in the capital account was so large that it necessitated a deficit in the overall balance of payments. Foreign reserves dropped from $26.6 billion to $16.6 billion or equivalent to 4.6 months of non-oil/gas imports.

The exchange rate crisis that began in July 1997 not only caused a large capital outflow but also invigorated a decline in capital inflow badly needed to finance investment activity and a crisis in private sector external debts. The large capital outflow was particularly evidenced in divestment of portfolio due to deteriorating foreign investors' confidence on Indonesia's economic prospects. The outflow was also perpetuated by the obligation to repay the mature private external debts.

**Table 2.3 Balance of Payments**

(Millions of USD)

| Descriptions | 1997/1998 | | | | 1998/1999 | |
|---|---|---|---|---|---|---|
| | I | II | III | IV | I | II |
| A. Current account | -1,102 | -1,1395 | -202 | -1,000 | 670 | 1,683 |
| I. Merchandise | 3,482 | 2,176 | 2,979 | 4,821 | 4,971 | 5,100 |
| 1. Exports, fob | 14,737 | 14,364 | 14,234 | 12,827 | 13,193 | 13,466 |
| a. Non oil and gas | 11,980 | 11,872 | 11,356 | 10,806 | 11,477 | 11,632 |
| b. Oil and gas | 2,757 | 2,582 | 2,878 | 2,021 | 1,716 | 1,834 |
| - Oil | 1,650 | 1,527 | 1,624 | 1,053 | 1,042 | 1,032 |
| - LNG | 976 | 967 | 1,123 | 911 | 622 | 751 |
| - LPG | 131 | 88 | 131 | 57 | 52 | 51 |
| 2. Imports, fob | -11,255 | -12,188 | -11,255 | -8,006 | -8,222 | -8,366 |
| a. Non oil and gas | -10,168 | -11,157 | -10,023 | -7,271 | -7,597 | -7,622 |
| b. Oil and gas | -1,087 | -1,031 | -1,232 | -735 | 625 | -744 |
| - Oil | -1,019 | -963 | -1,164 | -668 | -565 | -695 |
| - LNG | -68 | -68 | -68 | -67 | -60 | -49 |
| II. Service, net | -4,584 | -3,571 | -3,181 | -3,821 | -4,301 | -3,417 |
| 1. Non oil and gas | -3,446 | -2,404 | -1,932 | -2,740 | -3,772 | -2,737 |
| of which Net Income | -1,811 | -1,513 | -1,493 | -2,004 | -2,137 | -1,991 |
| 2. Oil and gas | -1,138 | -1,167 | -1,249 | -1,081 | -529 | -680 |
| - Oil | -549 | -516 | -546 | -498 | -294 | -292 |
| - LNG | -589 | -651 | -703 | -583 | -235 | -388 |
| B. Capital transaction | 2,226 | 1,790 | -5,442 | -6,203 | 1,195 | -399 |
| I. Official capital, net | 362 | -191 | 3,158 | 870 | 2,233 | 3,291 |
| 1. Inflows | 1,084 | 1,143 | 4,074 | 1,993 | 2,913 | 4,422 |
| a. IGGI | 1,078 | 1,141 | 4,068 | 1,130 | 1,219 | 1,294 |
| of which Net Current Transfer | --- | --- | 200 | --- | --- | --- |
| b. Non IGGI | 6 | 2 | 6 | 863 | 1,694 | 3,128 |
| 2. Debt repayments | -722 | -1,334 | -916 | -1,123 | -680 | -1,131 |
| II. Private capital, net | 1,864 | 1,981 | -8,600 | -7,073 | -1,038 | -3,690 |
| 1. Direct investment | 1,267 | 395 | -324 | -502 | 367 | -144 |
| 2. Others | 597 | 589 | -8,276 | -6,571 | -1,405 | -3,546 |
| C. Total | 1,124 | 395 | -5,644 | -5,203 | 1,865 | 1,284 |
| D. Errors and omissions, net 2) | 1,119 | -1,691 | -496 | 294 | 210 | 665 |
| E. Official reserves 1) | -2,243 | 1,296 | 6,140 | 4,910 | -2,075 | -1949 |
| MEMORANDUM | | | | | | |
| Official reserves position | 21,084 | 20,524 | 17,427 | --- | --- | --- |
| (In months non oil/gas imports c & f) | 5.6 | 5.2 | 4.5 | --- | --- | --- |
| - Gross Foreign Assets Outstanding | 28,854 | 27,559 | 21,418 | 16,509 | 18,584 | 20,533 |
| (In months non oil/gas imports c & f) | 7.7 | 7.0 | 5.5 | 4.6 | 6.6 | 7.3 |

Note:

1) Negative represents surplus and positive represents deficit.
2) Since 1997/98, Monetary Movements is based on Gross Foreign Assets replacing Official Reserves.

The significant decline in capital inflow was mainly purported by the delay of implementation of foreign direct investments already approved in 1997 and the years before.

The fall in capital inflow was also evidenced by the decline in private non-bank external borrowing. The key cause was the limiting access to external borrowing affected by the deteriorating Indonesia's rating internationally owing to its higher country risk.

The prolonged weakening of the rupiah exchange rate ultimately swelled the burdens for servicing the external debts. The strains became more apparent because of the significant amount of unhedged private external debts, the mismatch in financing long-term investments by short-term debts, and the use of the debts for non-foreign exchange generating activities. Moreover, the exchange rate crisis depressed international creditors' confidence on the ability of domestic debtors to repay their debts. Accordingly, the private sector faced difficulties in rolling over their mature debts resulting in the crisis in the private sector debts.

Meanwhile, the ratio of current account deficit to GDP narrowed from 3.5% to 1.3% in 1997/1998. The improvement was mainly due to a large drop in import growth as a consequence of the continued weakening of the rupiah exchange rate. The growth in total export was disheartening because of a sharp drop in oil/gas exports alongside the fall in oil price and weakened demand. Non-oil/gas exports, despite some constraints to seize export opportunities effectively, showed a vibrant growth as a positive impact of the rupiah depreciation.

To improve the balance of payments performance, in 1998 the Government introduced several measures covering both capital flows and international trades. Policies for capital flows centered on restoring confidence of foreign investors and on attracting their interests in investing in Indonesia. As such, the Government aims at stabilizing the rupiah exchange rates through raising interest rates. To bring in investors in the stock markets, the Government eliminated restrictions on the maximum amount that foreign investors could purchase shares at the primary markets, except for bank shares.

On the international trade front, the Government continues its efforts to promote efficiency in the real sector. One of the major policies issued in 1997 was the deregulation package of July 7 that covers both export and import. The deregulation package aims at enhancing economic efficiency and in perpetuating the Government's compliance with AFTA, APEC, and WTO agreements.

On the financing side, Bank Indonesia has provided swap and forward facility for selected exporters to ascertain the exchange rates for their foreign exchange receipts or payments. Bank Indonesia has also opened rediscount facility based on domestic letters of credit, and for export drafts originating from either post-shipment or pre-shipment. The policies allowed exporting companies to attain relatively inexpensive working capital for financing their production of export commodities. In addition, Bank Indonesia continued to permit state banks and foreign exchange licensed local government banks to obtain external borrowing and to issue bank guarantee for such debts.

Enhancing confidence of foreign counterparts in Indonesia's economic prospects is of importance to facilitate international trade, particularly import of raw materials and capital goods required for domestic production of outputs to meet both domestic and international demands. Bank Indonesia has set cooperation with international institutions to allow a guarantee facility for L/C issued by national banks. Bank Indonesia has also deposited funds in correspondent banks to facilitate L/C confirmation originating from national banks. The collaboration with monetary authorities from Singapore, Australia, the United States, and Japan, as well as the collaboration with international financial institutions, such as the US Exim Bank, the Exim Bank of Japan, and the Export Finance and Insurance Corporation of Australia, have produced several guarantee schemes for transactions initiated by Indonesian importers.

*A.4. Foreign Direct Investment*

The Indonesian government actively encourages foreign investment. Burgeoning infrastructure requirements and the desire to contain the increase of commercial indebtedness have reinforced the pro-foreign investment attitude. Foreign investment in industry, particularly in export-oriented and labor-intensive activities, is strongly encouraged.

The government is continuing to develop policies on the private provision of infrastructure through build-own-operate schemes, particularly for electric power, telecommunications, and roads. Although some sectors remain closed or restricted the government periodically updates its negative investment lists and list of sectors reserved for small business. In June 1994 and May 1995 several previously restricted sectors were opened to foreign investment, including harbors, electricity generation, telecommunications, shipping, airlines, railways, and water supply. Foreign investment opportunities in many services remain restricted, however.

The government's pragmatic attitude has led it to support a more extensive private sector role in the economy. Private entities may establish, acquire, and dispose of interests in business enterprises. Foreign investors may purchase domestic firms except in sectors prohibited by the negative list.

The Foreign Capital Investment Law of 1967, with later amendments, provides the basic framework for foreign investment. The Capital Investment Coordinating Board (BKPM) plays a key role in promoting foreign investment and approving project applications. Investments in the oil and gas, mining, banking and insurance industries are handled by the relevant technical government departments. All other foreign investment must be approved by BKPM, which also approves domestic investments when the owners seek investment incentives. BKPM aims to function as a one-stop investor service; however, investors should also work closely with relevant technical government departments and with regional and local authorities.

From 1967 through July 1996 (Table IV), BKPM approved foreign investment applications worth more than $164 billion; well over half were approved after 1992. Foreign investment approvals reached $40 billion in 1995, an almost 70 percent increase over 1994. Most approved investments in the past five years have been in manufacturing, especially in the chemical, textile, pulp and paper industries. Foreign investment in oil, gas, mining, banking and insurance all fall outside BKPM's purview; there are several billion dollars more annual foreign investment in these sectors.

**Table 2.4 Foreign Investment approvals**

(Millions of $)

| No. | Country | 1994 | 1995 | Jan-Jul ‘96 | 1967-Jul ’96 |
|---|---|---|---|---|---|
| 1. | Japan | 1,562.4 | 3,792.0 | 5,265.1 | 32,104.6 |
| 2. | Britain | 2,957.1 | 6,322.1 | 2,540.7 | 28,707.6 |
| 3. | Hong Kong | 6,041.7 | 1,763.3 | 1,048.7 | 18,318.0 |
| 4. | Singapore | 1,664.4 | 1,468.5 | 1,720.1 | 13,342.6 |
| 5. | U.S.A. | 977.0 | 2,770.6 | 515.1 | 12,305.9 |
| 6. | Netherlands | 165.7 | 360.1 | 1,210.8 | 10,472.3 |
| 7. | Taiwan | 2,487.5 | 567.4 | 397.0 | 9,160.7 |
| 8. | South Korea | 1,849.0 | 674.7 | 462.3 | 7,101.3 |
| 9. | Australia | 53.2 | 3,712.4 | 242.3 | 6,155.5 |
| 10. | Germany | 113.0 | 1,344.6 | 112.8 | 5,083.4 |

Note: Investment approvals exclude oil and gas and financial sectors.
Sources: Government of Indonesia, U.S. Department of Commerce, IMF.

Japan is the biggest cumulative foreign investor in Indonesia. Between 1967 and July 1996, BKPM-approved Japanese investment applications totaled $32 billion. In 1995, approvals of Japanese investment totaled over $3.7 billion. Indonesia's second largest oil company, Indonesia Petroleum, is a Japanese joint venture, as is the largest automobile manufacturer, PT Astra. Japanese partners also figure heavily in the pulp, paper and petrochemicals industries. Other Asian investors are particularly prominent in the labor-intensive textile, garment, and footwear industries.

*A.5. Borrowing from Abroad and Aid*

The government had successfully avoided a debt crisis in the early 1980s when many developing countries, including the neighboring Philippines, were forced to temporarily halt debt repayments. In a comparative study of Indonesia and other debtor nations, the success was due to two main factors: heavy reliance on long-term concessional loans and sustained high exports because of a willingness to devalue the exchange rate even when oil export revenues were buoyant. When dollar interest rates soared in the early 1980s, Indonesia's average interest rate on long-term debt was 16 percent compared with over 20 percent paid by Brazil and Mexico.

By 1990 Indonesia's total outstanding foreign debt had reached US$54 billion, more than double the amount in 1983. Over 80 percent of this debt was either lent directly to the government or guaranteed by the government. Measures to reduce foreign borrowing together with the rise in export earnings brought the debt service ratio from 35 percent in 1989 to 30 percent in 1990. Indonesia continued to rely heavily on borrowing from official creditors rather than private sources such as commercial banks or bond issues. In 1990 US$33 billion, or 75 percent, of government debt was from official creditors; of this amount, US$18.5 was at concessional terms. In 1990 US$5 billion in new loan commitments from official creditors were secured at an average interest rate of 5.7 percent, with an average maturity of twenty-three years, whereas US$1 billion in new commitments from private creditors entailed a 7.4 percent interest rate and an average of fifteen years maturity.

The mounting government concern over foreign debt led to the establishment of a Foreign Debt Coordinating Committee in 1991, which included ten cabinet ministers chaired by the coordinating minister for economics, finance, industry, and development supervision. The committee was given broad powers to document and coordinate all foreign borrowing that was related to either the central government budget or the state enterprise sector. Although in theory this debt excluded private-sector foreign borrowing, such borrowing could be included if the investment project received any state financing or supply contracts from state enterprises. The power of this committee was made apparent in its first initiative in 1991, which postponed until 1995 four major energy and petrochemical projects representing a total investment of US$10 billion.

Multilateral aid to Indonesia was long an area of international interest, particularly with the Netherlands, the former colonial manager of Indonesia's economy. Starting in 1967, the bulk of Indonesia's multilateral aid was coordinated by an international group of foreign governments and international financial organizations, the Inter-Governmental Group on Indonesia (IGGI). The IGGI was established by the government of the Netherlands and continued to meet annually under Dutch leadership, although Dutch aid accounted for less than 2 percent of the US$4.75 billion total lending arranged through the IGGI for FY 1991.

The Netherlands, together with Denmark and Canada, suspended aid to Indonesia following the Indonesian army shootings of at least fifty demonstrators in Dili, Timor Timur Province, in November 1991. The shootings led to international protests against government policy in the former colony of Portuguese Timor, which had been forcefully incorporated, into the Indonesian nation in 1976 without international recognition. Indonesian minister of foreign affairs Ali Alatas announced in March 1992 that the Indonesian government would decline all future aid from the Netherlands as part of a blanket refusal to link foreign assistance to human rights issues, and requested that the IGGI be disbanded and replaced by the Consultative Group on Indonesia (CGI) formed by the World Bank.

Indonesia's external debt at the end of 1995 was about $108 billion. The amount of external debt is continuing to grow since the fall in exchange value of rupiah getting down and the government needs it to overcome the crisis. Indonesia’s overall external debt position at the end of 1997/98 amounted to $137.9 billion, up from $113.1 billion at the end of March 1997. The government services its debt fully and has no plans to seek default.

A huge deficit in the private capital flows was responsible for such an unbearable outcome, outstripping the surplus in the government capital flows.. The crisis has rapidly eroded the confidence of foreign investors on Indonesia’s economic prospects. In addition, Indonesia’s rating was downgraded due to its higher country risk. As a consequence, the private sector has narrower access to acquire new offshore loans and to rollover existing matured debts.

In 1997/1998, debt service ratio (DSR) of the private sector rose from 19.6% to 29.5%, while that of the Government fell from 14.6% to 10.2%. The sharp increase in the private sector DSR reflected larger burden on external debts in line with the increased size of private foreign borrowing. Meanwhile, the decline in the government sector DSR resulted from a lower principal prepayment of debt in the reporting year. The financing structure that relied heavily on external sources deserves attention as confirmed by the rising ratio of external debts to GDP. The ratios of both the private and the government external debts to GDP rose from 26.1% and 22.7% to 44.0% and 28.5%, respectively. Likewise, the ratio of private debt outstanding to export increased from 100.1% to 129.2%, while that of government declined from 87.1% to 83.6%.

*A.6. Foreign Exchange Reserves*

Since January 1998, data on Indonesia’s foreign exchange reserves were recorded on the basis of the Gross Foreign Asset (GFA) concept, instead of official reserves that was previously used. Based on the new concept, the amount of Indonesia’s GFA in 1997/98 was $16.6 billion, a $10.0 billion decline from that in the previous year, or, in its equivalence, representing a fall from 7 months to 4.6 months of non-oil/gas imports. The decline in foreign exchange reserves resulted from a huge deficit in the balance of payments, originating mostly from the capital account deficit. To strengthen the reserves position, Bank Indonesia has withdrawn $3.0 billion under the IMF assistance program in November 1997 and $841 million from the standby loan up to the end of March 1998. Consequently, the remaining standby loan at the end of March 1998 stood at $1,044 million.

B. Domestic Environment

*B.1. Economic Growth Rate (GDP)*

The gross domestic product (GDP) has continued to grow as the industrial sector develops. Percentage GDP real growth is 8.2% in 1995, 7.8% in 1996, 4.8% in 1997 and –13.7% in 1998. The figure 2 mirrors composition of GDP in 1998.

*B.2. Inflation Rate*

Inflation, which was less than 5% in 1992, increased top approximately 9.5% in 1993 and 1994, but decreased to 8.64% in 1995. It decreased to 6.47% in 1996 and increased to 11.05% in 1997 and to 77.63% in 1998. Inflation in 1999 is expected to be contained in the 15-20 percent range.

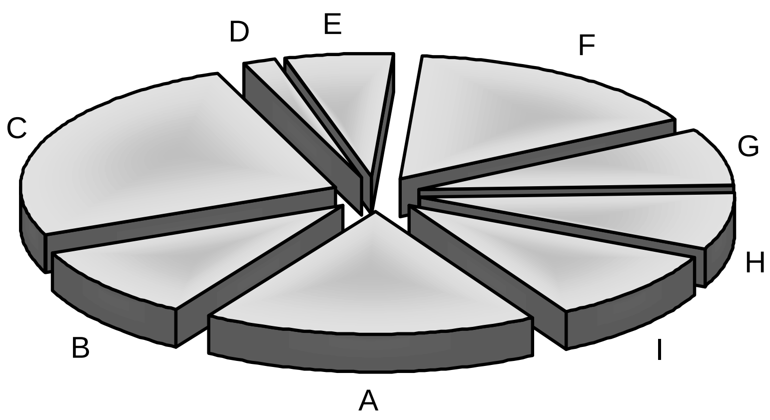
The table V mirrors Consumer Price Indices, that measures the average change in prices between times, of a package goods and services consumed by the population/household.

*B.3. Consumption, Investment and Capital Stock*

The year 1997/98 witnessed a considerable increase in government expenditures as compared to that in the previous year. The increase largely resulted from the actual expenditures that surpassed its projected stated in the budget. The depreciation of rupiah induced mounting foreign exchange expenditures, especially in term of interest payments and subsidies for fuel and basic needs. Fuel subsidy - which was not inscribed in the budget - reached Rp16 trillion reflecting attempts exercised by the government to restrain supply side inflation. In addition, fuel import subsidy registered a rise as well as a result of a discrepancy between domestic fuel consumption and domestic production capacity.

**Figure 2.2 Composition of GDP, 1998**

Total: Rp 374.7 trillion (1993 constant prices)




Legend:
A = Agriculture (17.2%)
B = Mining & Quarrying (9.8%)
C = Industrial Processing (25.3%)
D = Electricity, gas & water consumption ( 1.5%)
E = Construction (5.6%)
F = Trade, hotel & restaurant (15.9%)
G = Transportation & communication (7.5%)
H = Money & finance (7.6%)
I = Services (9.6%)
Sources: National Development Information Offices (NDIO)

Personnel expenditures looked out for an actual of 9.5% off the target as the appointment of government officials and the opening of government representative offices in several partner countries were postponed. On the contrary, material expenditures escalated by 1.5% beyond the targets as a result of larger overseas spending on goods.

Investment expenditures in 1997/98 rose essentially to 38.6% from 15.1% in the preceding year. The strong depreciation of rupiah enlarged the project aid expenditure, in spite of a lower value-in term of foreign currency-as compared with the budget. In view of preventing investment expenditures from further expansion, the government rescheduled programs/projects that put rupiah to import and postponed projects still in pipelines, besides retrenching official trips and building constructions. However, implementation of the projects that correlates with public welfare enhancement as well as poverty alleviation such as projects under Presidential Instruction, public health and basic education programs, and program of least-developed villages (IDT) remained on priority.

**Table 2.5 Consumer Price Indices Indonesia (1996 = 100)**

| Month | GROUP | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| | Food | Prepared Food, Beverages & Tobacco Products | Housing | Clothing | Health | Education Recreation & Sports | Transport and Communication | General |
| 1997 | | | | | | | | |
| December | 120.54 | 108.88 | 107.84 | 110.58 | 114.18 | 117.27 | 105.24 | 111.83 |
| 1998 | | | | | | | | |
| March | 166.71 | 142.23 | 128.61 | 161.39 | 155.88 | 134.74 | 119.74 | 142.15 |
| April | 176.56 | 153.16 | 131.56 | 168.39 | 164.12 | 136.76 | 125.65 | 148.83 |
| May | 183.42 | 159.28 | 136.99 | 176.01 | 168.06 | 138.69 | 147.33 | 156.63 |
| June | 196.39 | 167.92 | 139.17 | 195.29 | 171.97 | 140.84 | 150.38 | 163.89 |
| July | 220.27 | 184.01 | 146.93 | 219.23 | 186.41 | 150.44 | 155.57 | 177.92 |
| August | 240.31 | 200.02 | 153.51 | 225.73 | 197.99 | 160.18 | 159.83 | 189.13 |
| September | 261.00 | 205.95 | 155.92 | 225.22 | 204.49 | 162.17 | 163.18 | 196.23 |
| October | 256.16 | 207.21 | 157.35 | 220.97 | 208.58 | 162.83 | 163.60 | 195.70 |
| November | 255.70 | 208.64 | 158.11 | 215.99 | 210.71 | 162.34 | 163.47 | 195.86 |
| December | 263.22 | 211.58 | 159.03 | 219.71 | 212.54 | 161.84 | 163.70 | 198.64 |
| 1999 | | | | | | | | |
| January | 281.09 | 213.80 | 160.62 | 232.11 | 214.07 | 161.40 | 164.95 | 204.54 |
| February | 287.60 | 216.87 | 162.06 | 234.23 | 214.12 | 161.89 | 164.29 | 207.12 |
| March | 281.65 | 216.34 | 162.92 | 234.71 | 215.80 | 162.05 | 169.16 | 206.75 |

Source: Central Bureau of Statistic (Badan Pusat Statistik)

Indonesia's economy offers significant room for capital market growth. Although, for example, the country's GNP is much larger than that of neighboring countries Malaysia and Thailand, the stock market capitalization is estimated at barely one-third that of these nearby market.

*B.4. Money Supply*

Money supply (M2) grew by 27.6 percent in 1995 and by 29.6 percent from May 1995 to May 1996, substantially in excess of the 17 percent target set by the central bank, Bank Indonesia (BI). Domestic credit accounted for most of the growth, as total outstanding credit at commercial banks increased by 25 percent from May 1995 to May 1996. In late 1995 and early 1996, BI took a number of steps designed to slow the growth of domestic credit, which included raising the reserve requirements for commercial banks, requiring banks to submit credit plans, and extending BI's supervisory authority to finance companies.

*B.5. Employment*

The labor force is estimated at about 87 million in 1996, of which about 75 percent are between the ages of 15 and 34. The labor force has grown by an average of 2.5 percent over the past 30 years, though this rate is decreasing with the drop in fertility rates, increasing urbanization and lengthening school attendance.

**Table 2.6 Money and Finance Indicators**

| Year Ending December 31 | 1995 | 1996 | 1997 | 1998 | 1999 |
|---|---|---|---|---|---|
| Inflation (%) | 8.64 | 6.47 | 11.05 | 77.63 | 4.23* |

| | | | | | |
|---|---|---|---|---|---|
| Rupiah/US$ Exchange Rate | 2,308 | 2,383 | 4,650 | 8,025 | 6.875** |
| M2 Growth (%) | 27.6 | 29.6 | 23.2 | 62.34 | - |
| Credit Growth (%) | 24.2 | 24.9 | 32.9 | 28.9 | - |
| Jakarta Stock Exchange Index | 514 | 637 | 402 | 398 | 707** |

* through February

** through June 22nd

Source: *Monthly Statistical Bulletin*, Indonesia National Development Information Office

Women make up approximately 40 percent of the work force. Unemployment is roughly 4.6 percent. However, 37 percent of Indonesia's total labor force is under-employed. The under-employment rate is 45 percent in rural areas and 28 percent in urban areas. The education level of Indonesia's labor force continues to rise. Some 26 percent of non-agricultural workers have graduated from high school, and about five percent have educational achievement at a university level. Only 25 percent of the non-agricultural workers have not completed primary school, although this figure reaches almost 50 percent within the agricultural work force. The government is phasing in compulsory education through junior high school.

The government sets minimum wages by region. The minimum wage in Jakarta was set at Rp. 5,200 (approx. $2.25) per day as of April 1, 1996. Labor strikes have been common since 1992. Strikes usually relate to failure of employers to pay the minimum wage, denial of benefits, lack of an effective union, and termination of employees.

## C. Fiscal Position

By the end of 1993, Indonesia’s per capita GDP of US$ 814 (in 1993 prices) placed the country among lower middle income nations, as classified by the World Bank. Over the next three years, and by the end of 1996, per capita GDP had expanded by a further 40% to reach US$ 1,140 but the crisis made per capita GDP very low as US$ 610 as of 1998.

Prudent fiscal management has constituted a central and consistent strand of Indonesia’s macroeconomic strategy over the past three decades. An integral component of fiscal management is the principle of is the principle of balanced and dynamic state budget. This principle requires that the state budget both reflects a balance between total revenues and expenditures, while remaining dynamic in the sense of continuously providing for overall budget increases to maintain the momentum of development.

The primary policy target of government finance in Indonesia’s current Five-Year Development Plan (Repelita VI) is to enhance the capability of government funding. This is to be achieved mainly by improving domestic revenue capabilities, particularly taxes. Increased revenues expected to improve the state financing structure while increasing self-reliance by lessening dependence on financing from abroad. Additionally increased tax revenues will further reduce the country's dependence on receipts from oil and gas. Other important policy targets include increasing the efficiency and effectiveness of both the Government’s routine outlays and expenditures on development projects.

Indonesia’s state budget, incorporating proposed revenues and expenditures, is prepared by the Ministry of Finance in consultation with other government departments and institution and submitted by the President to the House of People’s Representatives (DPR) for approval each January for the next fiscal year beginning 1 April. If the house fails to approve the budget, the Government automatically readopts the budget of the previous fiscal year.

### *C.1 Government Revenue and Expenditures*

The exchange rate turbulence that began since the beginning of the second quarter of 1997/98 adversely affected government finances. Up to the second quarter of 1997/98, the government finance still recorded a surplus of Rp8.0 trillion. However, the continued rupiah depreciation and worsening economic performance in the second half of 1997/98 had caused a deficit in the finance as total expenditures surpassed total revenues. The increased expenditure was mainly attributed to a sharp increase in the fuel subsidy and foreign currency-related expenditures.

The government continued to consolidate fiscal position through austere budget expenditure and stern budget discipline. However, economic downturn necessitated an increase in the subsidy and interest payment on external debt. The measures to curb cost-push inflationary pressure resulted in higher foreign exchange subsidies for imported fuel and basic necessities. The rupiah depreciation had raised overseas expenditures for material and personnel expenses. Nevertheless, its insignificant share made the increase immaterial in term of material and personnel expenditures.

Meanwhile, to reduce pressures on the state finance, the government rescheduled a number of projects. Also, the government streamlined the budget financing and eliminated special treatments on strategic industrial projects in terms of tax facility, import duty, or credit for the national car project.

The year 1999/2000 witnessed a considerable increase in government expenditures as compared to that in the previous year. The increase largely resulted from the actual expenditures that surpassed its projected stated in the budget. The depreciation of rupiah induced mounting foreign exchange expenditures, especially in term of interest payments and subsidies for fuel and basic needs. Fuel subsidy-which was not inscribed in the budget-reflecting attempts exercised by the government to restrain supply side inflation. In addition, fuel import subsidy registered a rise as well as a result of a discrepancy between domestic fuel consumption and domestic production capacity.

**Table 2.7 Domestic Revenues 1989/1990-1999/2000**

| Fiscal Year | Oil Revenue | | Non Oil Revenue | | Total | |
|---|---|---|---|---|---|---|
| | billions of Rp. | % | billions of Rp. | % | billions of Rp. | % |
| F Y P V | | | | | | |
| 1989/1990 | 13,381.3 | 42.5 | 18,122.9 | 57.5 | 31,504.2 | 100.0 |
| 1990/1991 | 17,740.0 | 42.0 | 24,453.0 | 58.0 | 42,193.0 | 100.0 |
| 1991/1992 | 15,069.6 | 35.4 | 27,512.4 | 64.6 | 42,582.0 | 100.0 |
| 1992/1993 | 15,330.8 | 31.4 | 33,531.8 | 68.6 | 48,862.6 | 100.0 |
| 1993/1994 | 12,503.4 | 22.3 | 43,609.7 | 77.7 | 56,113.1 | 100.0 |
| F Y P VI | | | | | | |
| 1994/1995 | 13,537.4 | 20.4 | 52,880.6 | 79.6 | 66,418.0 | 100.0 |
| 1995/1996 | 16,054.7 | 22.0 | 56,959.2 | 78.0 | 73,013.9 | 100.0 |
| 1996/1997 | 20,137.1 | 23.0 | 67,493.2 | 77.0 | 87,630.3 | 100.0 |
| 1997/1998 | 35,357.0 | 32.7 | 72,826.8 | 67.3 | 108,183.8 | 100.0 |
| 1998/1999 (budget) | 49,711.4 | 33.3 | 99,591.1 | 66.7 | 149,302.5 | 100.0 |
| 1999/2000 (budget) | 20,965.0 | 14.7 | 121,238.8 | 85.3 | 142,203.8 | 100.0 |

Source: Ministry of Finance (http://www.depkeu.go.id/)

*C.2 Public Borrowing*

Indonesia has traditionally resorted to external borrowing rather than money creation to finance shortfall in the development budget. Most of Indonesia's external debts comprise loans provided on concessional terms, carrying interest of less than 3 percent. Indonesia's track record on the wise of use of foreign assistance for economic development, together with the country's overall economic stewardship and impeccable debt servicing performance, have been prime factors in maintaining the confidence of the international donor community.

The overall government finance in the 1999/2000 recorded a considerable deficit. This deficit was financed by foreign aid. It is worth noting that in recent years, to abate the distress in public finance, the government has accelerated amortization on commercial debt with high interest rate.

## 2.4 Tax Structure: Institutional and the Reality

Indonesia adopted major tax reforms in the 1980's, including a modern income tax in 1984, a Value Added Tax at the import and manufacturing stage in 1985, and a revised property tax in 1986. The Indonesian tax reform eliminated tax incentives for specific industries, exports, remote regions, technology transfers, and the listing company on the stock exchange. The expected revenue from the reform allowed the tax rates to be reduced. Indonesia adopted these new law based on four basic objectives i.e. simplicity, equity, enforceable and revenue enhancing. Following the reform, Indonesia experienced a sustained boom in domestic and foreign investment. Non oil revenues increased substantially.

**Table 2.8 Source of Financing for Development Expenditures 1989/1990-1999/2000**

(billions of rupiah)

| Fiscal Year | Development Expenditures | Sources of Financing | | | |
|---|---|---|---|---|---|
| | | Public Savings | % | Foreign Aids *) | % |
| F Y P V | | | | | |
| 1989/1990 | 15,393.9 | 7,169.0 | 46.3 | 8,330.3 | 53.7 |
| 1990/1991 | 18,250.8 | 13,071.9 | 60.9 | 8,381.5 | 39.1 |
| 1991/1992 | 23,074.5 | 13,529.0 | 57.6 | 9,975.1 | 42.4 |
| 1992/1993 | 26,906.3 | 15,257.2 | 57.9 | 11,097.9 | 42.1 |
| 1993/1994 | 28,428.1 | 15,823.2 | 59.5 | 10,752.5 | 40.5 |
| F Y P VI | | | | | |
| 1994/1995 | 30,691.7 | 22,349.0 | 69.4 | 9,837.8 | 30.6 |
| 1995/1996 | 28,780.7 | 22,578.9 | 71.5 | 9,008.8 | 28.5 |
| 1996/1997 | 35,951.7 | 25.069.2 | 69.4 | 11,048.1 | 30.6 |
| 1997/1998 | 46,938.0 | 23,577.6 | 49.7 | 23,817.0 | 50.3 |
| 1998/1999 (budget) | 92,683.0 | -21,902.6 | -23.6 | 114,585.6 | 123.6 |
| 1999/2000 (budget) | 82,448.3 | 5,048.3 | 6.1 | 77,400.0 | 93.9 |

Note: *) Up to 1998/1999 it was called project aids
Source: Ministry of Finance (http://www.depkeu.go.id/)

In 1994, Indonesia revised the 1980's tax reforms in order to intensify tax collection, to increase the number of taxpayers, 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. Indonesia reduced its highest marginal income tax rate from 35 to 30 percent, in a move designed to keep it competitive with its Southeast Asian neighbors. Indonesia also reintroduced incentives for investment in economic sectors with high economic priority, particularly the exports sector, as well as plantation and mines in 1995. A year later, Indonesia reintroduced 10-year tax holidays.

**Table 2.9 Indonesia's Tax Revenue and Gross Domestic Product 1989/1990-1999/2000**

(billions of rupiah)

| Fiscal Year | Taxes Revenue [1)] | G D P [2)] | Ratio (%) |
|---|---|---|---|
| F Y P V | | | |
| 1989/1990 | 16,084.1 | 148,101.8 | 10.9 |
| 1990/1991 | 22,010.9 | 172,840.3 | 12.7 |
| 1991/1992 | 24,919.3 | 200,702.1 | 12.4 |
| 1992/1993 | 30,019.5 | 236,644.4 | 12.7 |
| 1993/1994 | 36,665.1 | 308,184.4 | 11.9 |
| F Y P VI | | | |
| 1994/1995 | 44,442.1 | 365,750.9 | 12.2 |
| 1995/1996 | 48,686.3 | 433,903.9 | 11.2 |
| 1996/1997 | 57,333.9 | 505,986.2 [3)] | 11.3 |
| 1997/1998 | 64,066.3 | 621,099.9 [4)] | 10.3 |
| 1998/1999 (budget) | 72,930.8 | 760,251.3 [5)] | 9.6 |
| 1999/2000 (budget) | 94,739.7 | 904,443.1 [5)] | 10.5 |

Note:

1. Including import duties, excises, and export taxes (excluding regional taxes and retributions)
2. Non oil GDP in Fiscal year (quarterly BPS Publication)
3. Revised Preliminary
4. Preliminary
5. Estimation Figure

Source: Ministry of Finance (http://www.depkeu.go.id/)

**Table 2.10 Major Components of Non Oil Revenues 1989/1990-1999/2000**

(billions of rupiah)

| Fiscal Year | Income Tax | Value Added Tax | Import Duties | Excises | Land and Building Tax |
|---|---|---|---|---|---|
| F Y P V | | | | | |
| 1989/1990 | 5,754.8 | 5,986.1 | 1,892.2 | 1,482.2 | 604,4 |
| 1990/1991 | 8,250.0 | 8,119.2 | 2,799.8 | 1,799.8 | 785,8 |
| 1991/1992 | 9,727.0 | 9,145.9 | 2,871.1 | 1,915.0 | 944,4 |
| 1992/1993 | 12,516.3 | 10,742.3 | 3,223.3 | 2,241.6 | 1,106.8 |
| 1993/1994 | 14,758.9 | 13,943.5 | 3,555.3 | 2,625.8 | 1,484.5 |
| F Y P VI | | | | | |
| 1994/1995 | 18,764.1 | 16,544.8 | 3,900.1 | 3,153.3 | 1,647.3 |
| 1995/1996 | 21,012.0 | 18,519.4 | 3,029.4 | 3,592.7 | 1,893.9 |
| 1996/1997 | 27,062.1 | 20,351.2 | 2,578.9 | 4,262.8 | 2,413.2 |
| 1997/1998 | 28,458.2 | 24,501.0 | 2,989.5 | 4,807.2 | 2,655.0 |
| 1998/1999 (budget) | 25,846.2 | 28,940.0 | 5,494.9 | 7,755.9 | 3,411.0 |
| 1999/2000 (budget) | 40,626.0 | 34,597.4 | 2,950.3 | 10,160.0 | 3,247.0 |

Note: Since 1998/1999 including duties on ownership transfer of land and building (BPHTB)
Source: Ministry of Finance (http://www.depkeu.go.id/)

A. The Indonesia primary tax laws

1. Law Number 9 Year 1994 on Amendment of Law Number 6 Year 1983 on General Rules and Procedures of Taxation
2. Law Number 10 on Amendment of Law Number 7 Year 1983 on Income Tax as Amended by Law Number 7 Year 1991
3. Law Number 11 Year 1994 on Amendment of Law Number 8 Year 1983 on Value Added Tax on Goods and Services and Sales Tax on Luxury Goods.
4. Law Number 12 Year 1994 on Amendment of Law Number 9 Year 1983 on Land and Building Tax.
5. Law Number 13 Year 1994 on Amendment of Law Number 10 Year 1983 on Stamp Duty.
6. Law Number 10 Year 1995 on Customs.
7. Law Number 19/1997 on Tax Collection of A Distress Warrant
8. Law Number 21/1997 on Conversion of Land and Building Ownership Tax

Key Features of Indonesia's Tax Reform

1983 Reforms

§28707 Simplification of tax codes and specific taxes and broadening of the tax base

§28707 General lowering of income tax rates; uniform top marginal rate of 35% replaces previous rates of 50% for individuals and 40% for corporations

§28707 Introduction, with effect from April 1985, of new consumption taxes (to replace previous sales tax), in the form of:

-105 flat rate 10% value added tax on goods and services

-105 sales tax on luxury goods, ranging from 10% to 35%

1994 Reforms

§28707 Reduction in direct income tax rates of approximately one-third, with the top marginal rate on individuals and corporations reduced to 30%

§28707 Basic allowance deductions roughly doubled

§28707 Additional flexibility introduced for depreciation assets

§28707 Tax incentive facilities introduced for certain investments in certain activities, e.g. certain export activities; and/or in more remote regions, e.g. the eastern part of Indonesia

§28707 Expenditure on training, R & D and environmental protection now tax deductible

§32243 Widening of tax base, e.g. imposition of 15% tax on off-shore deposits place through banks operating in Indonesia; 5% capital gains tax on certain land transaction; 10% tax on the sale price of luxury residences

§32243 Improvements to increase transparency and efficiency of tax system, and secure increased compliance with regulations, including stiffer penalties

B. Sources of tax

Indonesia's tax revenues are drawn from four broad categories: Personal and corporate income; Domestic consumption, including value- added (VAT), sales tax on luxury goods, excise and miscellaneous taxes; Real estate; and International trade, comprising import and export tariffs and sales taxes on imported commodities.

The principal taxes in Indonesia are national and regional taxes and customs and excise duties. National taxes include individual and corporate income tax, value-added tax, sales tax on luxury goods, stamp duty and tax on land and buildings. The regional taxes include development tax, motor vehicle tax and miscellaneous taxes, including entertainment tax. Export duties, import duties, and duties on tobacco and alcohol are the principal customs and excise duties.

Actual tax receipts are derived chiefly from corporate earnings, personal income, domestic consumption, excise and import duties. Major proposals in the FY 1999/2000 State Budget include a 57.2 percent increase in income tax receipts to Rp 40.63 trillion; a 19.9 percent jump in VAT and Sales Tax on Luxury Goods to Rp 34.6 trillion; excise duties up by 20.7 percent to Rp 10.16 trillion; and export duties up by 175.2 percent to Rp 2.95 trillion.

C. General Rules and Procedures of Taxation

*C.1. Tax Administration*

In general, every taxpayer must register with the Directorate General of Taxes (DGT) to obtain a tax identification number. However individuals with single sources of employment income are not required to obtain a tax identification number.

The tax year for a company is generally the company financial year. The tax year may be changed only with the approval of the DGT. The tax year for individuals is the calendar year.

Taxpayers must prepare both monthly and annual returns. Monthly returns, which are require for corporate tax, employee income tax, VAT and withholding tax, must be filled no later than the $20^{th}$ of the month following the month of payment or accrual of the related expense. Annual returns must be submitted within three months after the end of the financial years unless an extension is requested. Late filling of returns is subject to an administrative fine of Rp 50,000 for annual returns and Rp 25,000 for monthly returns.

The Indonesian income tax system follows the concept of self-assessment. However, the tax authorities have the right to issue an assessment within 10 years after the fiscal years-end. An additional assessment also may be issued if new information arises as a result of an audit. By law tax authorities have full access to a taxpayer's record for 10 years after the end of the fiscal year. After a tax audit, the DGT may issue a tax assessment or decision letter on tax overpayment. If a tax assessment is not issued within 10 years, the tax return is considered final.

Objections against tax assessments must be filled with the DGT within three months after the date of the assessment. A decision on the objection must be issued within 12 months, or the objection may otherwise be considered accepted. A taxpayer may appeal to the Tax Court against a decision of the DGT within three months of the decision date. The submission of an objection or appeal does not postpone the obligation to pay the tax.

Tax must be paid in advance by monthly installments, which are due on the $15^{th}$ day of the month for corporate income tax and the $10^{th}$ day of the month for individual tax income tax and withholding tax. The amount of the installments is computed by first determining the highest of the previous year's tax payable according to the tax return and the tax payable in the two most recently assessed at years prior to the current year. For the initial year of operations, the tax is annualized, based on actual monthly taxable income. For banks and finance leasing companies, monthly tax installments are based on quarterly results.

For financial years ending on 31 December, any balance of tax due must be paid 25 March of the following year. In the case of an overpayment, a refund or future right of sector may be obtained after the completion of tax audit.

Interest of 2% a month for up to a maximum of 24 months may be levied on short payments. For additional assessments or routine late payments, the penalty is 100% of the tax due. Taxpayers may amend a tax return within two years after the end of the relevant fiscal year if the tax return has not been audited by the tax authorities. A return may be amended after two years only if the amendment would result in an increase in tax liability or would decrease tax losses. If a tax return is not filed despite a warning letter issued by tax office, or if the taxpayer is found to have kept inadequate books and records or has no supporting documentation, administrative sanctions of 50% or 100% of the underpaid tax may be levied.

*C.2. Tax Collection*

In addition to modernizing and standardizing tax regulations, Indonesia's tax reforms have focused on upgrading tax collection through simplification of procedures, computerization and payroll withholding. These advances have enhanced the revenue base and accelerated the flow of funds to the government. In fiscal year 1995/96, tax receipts reached some 68 percent of domestic government revenues, compared to just 34 percent in 1985/1986. During that period, these revenues increased five-fold from Rp 6.6 trillion to Rp 45 trillion.

The DGT has approximately 800 people engaged in the collection of outstanding taxes and the pursuit of late filers. A single collection unit, responsible for collection of all tax arrears exists within each District Tax Office (DTO). Tax collection officers identify, through the tax accounting systems, taxpayers that have failed to file tax return or pay their full tax liabilities. Collection specialist at DTO level follows a prescribed series of action to effect collection of the tax arrears.

**Table 2.11 Tax Arrears (in million of rupiah) 1996-1998**

| No. | Type of Tax | 1996 | 1997 | 1998 |
|---|---|---|---|---|
| 1. | Income Tax | 3,460,034.6 | 3,951,429.9 | 6,240,794,107 |
| 2. | VAT & Sales Tax | 1,476,234.8 | 1,870,946.8 | 2,336,388,877 |
| 3. | Other Taxes | 170,658.9 | 160,646.1 | 209,782,473 |
| 4. | Total Tax Arrears | 5,106,928.3 | 5,983,022.8 | 8,786,965,457 |

Source: Directorate General of Taxes, RI

*C.3. Auditing of Taxpayers*

The DGT has 5,441 staff engaged in audit operations. 1,878 are regarded as professional auditors and are located in the DGT headquarters, 15 Regional Offices and 55 Tax Audit Offices (TAO) across the country. The remaining 3,563 audit inspectors are located in 141 DTOs where less complex audits are performed.

The formal audit program carried out mainly by the professional audit staff. Taxpayers are selected for audit on the basis of 13 criteria, including taxpayers claiming refunds or losses, changes in the status of the business, information from third parties and the analysis of such items as profit ratios and inventory turn over. Audit teams of at least two auditors conduct field audits. The average duration of field audit is approximately two months and for a desk audit the average time required is three weeks. Targets are not set nor results reported in respect to the time spent on audits.

A national audit plan is prepared every year, along with regional and district plans, describing the number of audits to be performed for each category of audit. Results are reported monthly by each DTO, including the number of audits performed the additional tax assessed, and the amount of penalties imposed.

*C.4. International Taxation Agreements*

In order to prevent the double taxation of foreign national residing and working in Indonesia, the government has concluded tax treaties with over 40 nations. 32 treaties have been implemented. The list of the treaty as mirrors at the Table 2.12.

**Table 2.12 The List of Tax Treaty Rates between Indonesia and Foreign Countries**

| No | Country | Starting Date | Dividend | | Interest | | | Royalty | | Rates |
|---|---|---|---|---|---|---|---|---|---|---|
| | | | Portf. Invest | Direct Invest | General | Spec Case | Cent Bank | General | 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% | 15% | - | 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% |
| | Renegotiations | 01/06/94 | 15% | 10% | 10% | - | 0% | 10% | - | 9% |
| 17 | New Zealand | 01/06/94 | 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% | 10% | 0% | 15% | - | 10% |
| 20 | Philippines | 01/01/83 | 20% | 15% | 15% | - | 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 | UK | 01/01/76 | 15% | 10% | 10% | - | 0% | 15% | 10% | 10% |
| | Renegotiations | 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: *Directorate General of Taxation*, Directorate of International Tax Affairs 1997

D. Income Tax

The Income Tax is Indonesia's most important revenue source (see Table 2.10). Over 60% of income tax revenue come through withholding on wages, withholding on sales and imports, final withholding on interest, and other miscellaneous withholding. Before the economic downturn, business accounted for twice as much income tax as individuals.

Income is broadly defined. It includes, but is not limited to, business profits, gains from sales of transfers of assets, foreign exchange gains, interest, dividends, (except dividends paid by resident companies to other resident companies), royalties and rentals and other income related to the use of property.

Interest earned by resident companies on time deposits, certificates of deposit and savings account in Indonesia is subject to a 15% final withholding tax. A final 20% (or lower rate provide in a relevant tax treaty) withholding tax is imposed on interest earned by non-resident companies.

A 0.1% final withholding tax is imposed on proceeds of sales of publicly listed shares through any Indonesian stock exchange. A 5.1 % final withholding tax is imposed on gains from sales of founder shares associated with a public offering of shares. Other capital gains derived by residents are included in taxable income and are subject to tax at the normal progressive income tax rates. Other capital gains derived by non-residents are subject to tax at a rate of 20%. The law provides that the 20% tax is imposed on an amount of deemed income. The method of determining this deemed income amount has not yet been established.

Transferor of land or buildings must make advance payments of tax equal to 5% of the value transferred. However, if the transferors are taxpayers engaged in the business of transferring property, final tax is imposed at a rate of 2%-5% of the value of the property transferred.

Resident and Non-Resident Taxable Entities

Under Indonesian Law, resident individuals and corporations are taxed at a 30% maximum rate. The tax system is based on the concept of self-assessment, but has extensive provisions for dividends, interest, royalties, rentals and fees for professional, technical and management consulting services, construction services and other services determined by the DGT.

For taxation purposes, foreign residents are classified in three groups:

- Individuals present in Indonesia for more than 183 days in any tax year;
- Companies and organizations located in Indonesia;
- Non-resident corporations deemed to have a "permanent establishment" in Indonesia. For corporations from countries with which Indonesia has a tax treaty, a permanent establishment is considered to exist should its employee(s) be present in Indonesia for business purposes for more than 183 days in a 12-month period. For non-treaty countries, permanent establishment status applies from the date the employee(s) arrive in Indonesia for business purposes.

Non-residents - those earning an income while residing in Indonesia for 183 days or less in any 12-month period - are generally subject to withholding tax.

Statutory tax rates for various tax bases

Taxable income is subject to tax at the following rates apply to domestic taxpayers and corporate taxpayers:

| Taxable Income | | Tax on | Rate on |
|---|---|---|---|
| Exceeding | Not Exceeding | Lower Amount | Excess |
| Rp | Rp | Rp | % |
| 0 | 25,000,000 | 0 | 10 |
| 25,000,000 | 50,000,000 | 2,500,000 | 15 |
| 50,000,000 | ~ | 6,250,000 | 30 |

With a few exceptions, three rates apply to the annual rupiah (Rp) incomes of both individuals and corporations. The 1994 tax law reforms provide additional incentives to investment through a general lowering of income tax rates. For corporations operating in the oil, gas and mining industries, tax regulations are specified in the terms of their contracts. In general, such rates are consistent with the current tax laws or tax laws established prior to the 1984 tax reform. Both individuals and corporations are entitled to a range of tax allowances. For corporations, routine business expenses, together with employer contributions to the government-approved employee pension plans are deductible from taxable income.

**Table 2.13 Special tax rates**

| Companies | Tax rate applied | Notes |
|---|---|---|
| Petroleum Companies | 1. Flat rate of 35% or 45%<br>2. 20% withholding tax | 1. Depend on contracts<br>2. May be reduced by certain tax treaties on their after-tax taxable income |
| Mining Companies | 1. 30%-40%<br>2. 20% or 10% for dividend withholding tax | 1. Depend on contracts<br>2. Depend on contracts |
| Foreign Drilling Companies | 1. 15% of the gross turnover (deemed profit) | |
| Non-resident International Shipping Co. and Airlines | 1. 2.64% of gross turnover. | |

Source: Doing Business in Indonesia-E & Y International.

The after-taxable income of a permanent establishment not protected by a relevant treaty is subject to a final tax at a rate of 20%. The tax applies regardless of whether the income is remitted. The payment of this tax may be relieved under certain circumstances if the income is reinvested in Indonesia.

Companies incorporated or domiciled in Indonesia are subject to income on worldwide income, though credit is available for income tax overseas. A company is domiciled in Indonesia if it is managed, controlled or has its head office in Indonesia. Branches of foreign companies are taxed only on those profits derived from activities carried on Indonesia. However, income accruing from Indonesia to a foreign parent or related company is taxed as income of the branch if the nature of the business is similar to the business of the branch.

Special tax rates apply to the company described in Table XIII above.

*D.1. Withholding Taxes*

The Indonesian tax system relies heavily on withholding taxes. For resident taxpayers, withholding tax is treated as an advance payment of annual income tax liability. For non-resident taxpayers, withholding taxes are final taxes. The following withholding tax provisions are set forth in Law No. 10 of 1994.

Article 22

Under Article 22 of Law No. 10 of 1994, withholding tax is levied on the cost, insurance and freight value of imported goods at a rate of either 2.5% or 7.5%. Payments from the government for services funded by the budget are subject to withholding tax at a rate of 1.5% tax to be deducted by the state treasury or state-owned companies or organizations. Products delivered by specified industries are subject to withholding tax at rates determined by the DGT.

Article 23

Under Article 23 of Law No. 10 of 1994, resident corporate taxpayers and certain individuals must deduct withholding tax from the following payments to resident taxpayers, other than banks, at a specified percentage of the gross amount of the payment.

**Table 2.14 Payments are subject to withholding tax Under Article 23 of Law No.10 of 1994**

| No. | Type of Payment | Rate of the gross amounts |
|---|---|---|
| 1 | Dividends payable to individuals | 15% |
| 2 | Interest, including premiums, discounts and guarantee fees | 15% |
| 3 | Gifts | 15% |
| 4 | Royalties | 15% |
| 5 | Rentals and other payments for the use of property than land or buildings | a. 6%(payments to company & permanent establishment)<br>b. 10%(payments to individuals) |
| 6 | Compensation related to technical services, management services, consulting services and other services specified by the DGT, except those services already subject to income tax withholding under Article 21, which governs the income taxation of individuals. | 6% |

Source: Doing Business in Indonesia-E & Y International.

Under Government Regulation No. 73 of 1996, dated 20 December 1996, and effective from 1 January 1997, individuals and organizations that derive income from construction or consulting services (except legal and consulting services) are subject to final income tax on gross income at the following rates: Construction contracting services;2%, Construction planning services;2%, Construction supervision services;2% and Consulting services;2%.

Article 26

Under Article 26 of Law No. 10 of 1994, the following payments by a resident taxpayer to a non-resident taxpayer are subject to withholding tax at a rate of 20% of the gross amounts:

1) Dividends
2) Interest, including premiums, discounts and guarantee fees
3) Royalties, rents, and other income with respect to the use of property
4) Compensation for technical, management and other services
5) After-tax profits or permanent establishment
6) Insurance premium
7) Income derived from the disposal of property

*D.2. Tax Privileges*

Article 31A of the Law Number 10 on Amendment of Law Number 7 Year 1983 on Income Tax as Amended by Law Number 7 Year 1991, creates wide powers to Government Regulations to grant Tax Facilities for investors in certain business sectors and/or in certain regions.

Government Regulation No. 45 of 1996 introduced tax holidays for newly-incorporated firms operating in certain industries for up to ten years (twelve years outside Java and Bali) together with income tax exemption for dividend paid abroad. The privileged industries were to be determined by Presidential Decree, on the basis of recommendations from an Investigatory Team on Tax Facilities on Certain Industries.

*D.3. Miscellaneous Matters*

Under the tax law, the Minister of Finance may determine an acceptable debt-to-equity ratio. However, the minister has not yet announced such a ratio. If there is a special relationship between two taxpayers that might provide tax advantages; the DGT has the authority to determine income and deductions and to reclassify loans as equity.

Related party loans may be treated as equity investment, with the interest expenses disallowed for the tax purposes. Indonesia has no transfer pricing legislation. However, in 1993, the DGT issued transfer pricing guidelines, acceptable transfer pricing methods include comparable uncontrolled price, resale price, cost plus or any other method appropriate under the circumstances, such as profit split and return on investment.

## E. Value Added Taxes and Sales Tax on Luxury Goods

Introduced under the tax law of 1984, and replacing the previous general sales tax, VAT is currently applied at a flat rate of 10 percent to defined groups of goods and services. VAT is paid by manufacturers, importers, wholesalers and retailers of taxable goods and services, with the final cost being passed on to end-users. Retailing was brought within the VAT scheme for the first time in April 1992. The 1984 tax law also provided for a separate sales tax currently ranging from 10 to 50 percent on luxury items. VAT deferments may be authorized by the Indonesian government on capital and luxury goods for domestic and foreign investment projects and on services related to the exploration of oil, gas and geothermal steam until commercial production is achieved. VAT and Sales Tax are applied at a zero rate to exports in order to encourage exports. For imports, these sales taxes are collected at the point of import and are calculated based on the value of the product, including import duties. The VAT raised 31 percent of non-oil revenues in 1997/98 while the sales tax raised 4 percent.

In addition to VAT, a sales tax is imposed on luxury goods manufactured in Indonesia and on imported luxury goods. This tax applies once only, at delivery by the manufacturer or at the time of import. The applicable tax rates are 10%,20%, 25%, 35% and 50%, depending on the category of goods.

The liability of VAT and sales tax on luxury goods arises at the time of delivery of the goods arises at the time of delivery of the goods and services or receipt of payment, whichever is earlier. However, the base date to determine the date of payment of the tax liability is the date of the tax invoice. The taxable individual or corporation must issue the tax invoice at the latest by the end of the month following the month of delivery, or the month of payment, if payment is received prior to delivery. A monthly return of all taxable purchases and sales must be filled by the twentieth day of the month following the date of issuance of the tax invoice.

If output for VAT is greater than input VAT, the net difference is payable to the tax office on the fifteenth of the month following the date of issuance of the tax invoice. In practice, payment of tax maybe delayed up to a maximum of 75 days after the date of delivery. If input VAT is greater than output VAT, the excess may be carried over the following months. In general, the excess of input VAT over output VAT may be refunded once a year. However, for certain exporting companies, including companies dealing with VAT collectors, excess input VAT may be refunded on a monthly basis, up to a maximum of 7% of the company’s monthly sales.

## F. Land and Building Tax

Individuals and organizations that have certain rights to or obtain benefits from land or possess control or obtain benefits from ownership of land or buildings are subject to land and building Tax.

The tax base is the sales value of the land and buildings. Sales value is determined by the Ministry of Finance every three years in most areas and every year in rapidly developing areas. The current effective rate of land and building tax is 0.1% of the taxable sales value. Buildings value at up Rp 8 million are exempt from the tax.

The tax year for the land and building tax is the calendar year. The tax is calculated on the basis of the taxable sales value of the property at 1 January. Those subject to taxation must register within 30 days of receipt of the form from the DGT. The directorate then issues an assessment, which must be paid within six months after the date of the tax assessment letter.

## G. Stamp Duty

Stamp Duty is payable on the following documents:

- Agreements letter of authorization or other papers of a civil nature that could serve as evidence at a rate of Rp 2,000 per document;
- Notarial deeds, including copies issued by notaries, at a rate of Rp 2,000 per document; and
- Authorized land certificates and duplicates at Rp 2,000 per document

Stamp duty is also payable on drafts, promissory notes, acceptances, cheques, securities, receipts, bank statements and supplier statements.

The following are exempt from stamp duty: certificates of goods storage, bills of lading, certificate of passenger and goods transport, notes on goods received and delivery notes, diplomas, salary receipts, letter of evidence on receipt of funds from banks or state and regional treasuries, internal receipts, documents mentioning saving or payments of savings and letters of distribution of profit or interest from securities.

## H. Customs and Excise

### *H.1. Customs*

The custom administration has undertaken a comprehensive approach to reform since 1985 with changes being introduced in legislation, procedures, computerization, and organizational structure. The custom tariff is now based on the World Customs Organization Harmonized System, which was initially introduced on January 1, 1989.

Custom Law No. 10/95 was implemented on April 1, 1997, coinciding with the termination of PSI. Implementation of the law, supporting regulation and procedures introduced fundamental changes into all aspect of customs administration. The important principles upon which the law is based include: self assessment, selective physical inspection, post release controls, including the auditing of the books and records of importers, and presentation of declarations electronically. In support the new legislation, information technology is being used extensively, thereby, supporting the simplification of procedures aimed at improving operational efficiency.

Beginning in early 1997, all pre-shipment inspection will be phased out and the Indonesian customs department will resume its full authority over customs valuation. Indonesia is a party to the Pre-Shipment Inspection Agreement, which grew out of the Uruguay Round GATT Agreement.

### *H.2. Excise Taxes*

Excise taxes, which apply to alcohol and tobacco products, are administered and collected by the Directorate General Customs and Excise (DGCE). Approximately 1,000 staffs are involved in the administration of the excise taxes on domestic production. Physical control is exercised over inventories of tobacco and alcohol products by customs staffs assigned to surveillance of each production plant. Imported and domestic tobacco product s requires an excise stamp as proof that appropriate taxes have been paid.

Domestic taxpayers are liable for the excise tax associated with each excise stamp they receive. Payment of the tax is to be made two months from the date the stamps are ordered by the taxpayers. Producers of hand-rolled cigarettes are given three months to pay the tax.

## I. Taxes on International Trade

In the most recent deregulation package, the Government announced certain measures it would take to facilitate exports. The steps appear to be aimed at reducing and simplifying the permits required by producers and exporters, such as certificates of origin. In addition, certain export companies will receive customs services and tax facilities for their export products. The package also referred to facilitation in the banking sector.

The government urges exporting foreign investors to locate in bonded or export processing zones. There is a duty drawback facility (BAPEKSTA) for exports located outside the zones, but repayments can be subject to long delays, which reduce the incentive to use the facility and hence reduce the incentive to export. Producers located within the bonded areas are allowed to release up to 15 percent of their production into the local market. Export regulations apply to rattan, sawn timber, processed wood, and sandalwood. Export taxes or export surcharges are levied on rattan, hides, timber, and related processed products.

In recent years, the government has reduced or eliminated tariff and non- tariff barriers on thousands of imported items, including automobiles, automotive spare parts, factory equipment, newsprint, plastic printing paper, sawn timber, sunflower seed oil and textile products. Approved foreign capital investment companies may be exempt from import duties on capital good and raw materials. Businesses that purchase capital goods manufactured in Indonesia and that import raw materials subject to import duties for use in the production of export goods may recover the duties. Companies in the manufacturing and service sectors may defer payment on VAT imports of capital goods for a period of up to five years. In some circumstances, this deferral effectively represents an exemption from VAT.

## J. Impact of the economic crisis to taxation

The impact of the economic crisis can be expected to be particularly pronounced in the annual yield of the corporate income tax, once the lag inherent in the collection system is exhausted. Specifically, foreign exchange losses, depressed domestic demand, and disruptions in trade credit and distribution channels probably wiped out some proportion of the tax revenue during the last fiscal year and the current fiscal year. Also withholding on income remittances abroad declined.

The problems that taxation is likely to face due to the current monetary crisis are: tax compliance, company restructuring and company insolvency, custom revenue has declined sharply due to the reduction in certain import duties and due to the increase in the proportion of nondutiable import of total import, asset revaluation, the status of debts owed by and to taxpayers, tax holiday, personal allowances, final Tax, collection of Tax Arrears, counterfeit invoices etc.

Although the crisis still exists, the tax revenue for Fiscal Year 1998/1999 recorded a surplus of Rp 5.46 trillion. The tax revenue target is Rp 81.72 trillion and the realization is Rp 87.18 trillion. The main source of the surplus is income tax (63%).

There are mainly four sectors that made the tax revenue get surplus i.e. agribusiness sectors, sectors related to foreign exchange revenue like rental, royalty and expatriate and oriented export industries using domestic raw material. The other good news are the surplus came from the middle and small entrepreneurs who have no foreign debt, and the amount of taxpayer increase of 5%.

In the short term, tax revenue seems unaffected because policies made by the DGT before the crisis begun were helpful. But the tax revenue surplus is not only due to the DGT efforts but also because of high interest rate applied to deposits. In the future, the DGT can not count on the policy that was made by another institution. The DGT has to improve itself since there are many things to do in order to increase government revenue.

## 2.5 Country-Specific Fiscal Issues

A. The Crisis

The monetary crisis in Indonesia was originally perceived in industrial nations and international financial circles as a temporary shock to be resolved mainly by short run measures in the debtor nations. It gradually became clear that much longer term; more complex issues were involved. It was getting worse and worse since Indonesian economy is vulnerable to capital flight; its financial system is closely linked to the dollar and its diversified export sector can not adapt quickly to changes in trade flows. The Indonesian monetary crisis is an example of a country whose economic policy was defeated by a fast-growing global economy

In the early period of the crisis it seems Indonesia had the same mixture of options: drawing down its foreign exchange reserves, increasing overseas borrowing, deficit financing, or devaluation to overcome the crisis like it had before in 1983 and 1986. But the current crisis situation is very different. No choice, Indonesian Government has to ask for a rescue plan from IMF.

The IMF announced a multibillion-dollar assistance package that was intended to restore confidence to Indonesia beleaguered economy but troubles afflicting Indonesia were deeper and more intractable than had been presumed. Key elements of the program offered by IMF included monetary policy tightening, strengthening of the banking system, and a set of structural reform measures to enhance efficiency and transparency in the corporate sector. However, uneven program implementation and increasing political uncertainty in the ensuing months led to intensified capital outflows and a precipitous decline in the value of the rupiah.

And the crisis became worse while the New Order Government lead by Suharto applied IMF recipes very slowly. In January 1998, after President Suharto announced the details of the state budget that was out of line with IMF expectation, the financial crisis became worse and worse. Four months later, Suharto could stand the pressure from Indonesian society no more. Monetary instability was one of the factors that led to the decline of the Suharto regime.

The new Government of Indonesia under Habibie is committed to rapid stabilization of the economy and to implement far reaching structural reforms. Still, the economic situation in Indonesia remains precarious. The massive restructuring of the banking system and the corporate sector, the social disturbances that occurred frequently, many riots that occurred in some regions and the ongoing economic crisis in the region continue to weigh heavily on the Indonesian economy.

The fall in exchange rate of the Rupiah from around \$1:Rp 2,500 in July 1997 to around \$1:Rp 8,800 as of April 1999 has created large exchange gains for some businesses holding net foreign currency assets, but much more commonly has created massive losses for businesses that have borrowed in foreign currency for investment in domestic asset. The domestic purchasing power of the Rupiah that has halved made the balance sheets of many corporations unrealistic.

The monetary crisis in Indonesia was originally perceived in industrial nations and international financial circles as a temporary shock to be resolved mainly by short run measures in the debtor nations. It gradually became clear that much longer term; more complex issues were involved. And the crisis became worse while the New Order Government lead by Suharto applied IMF recipes very slowly. It was getting worse and worse since Indonesian economy is vulnerable to capital flight; its financial system is closely linked to the dollar and its diversified export sector can not adapt quickly to changes in trade flows. The Indonesian monetary crisis is an example of a country whose economic policy was defeated by a fast-growing global economy.

The Indonesian Government has concluded that as a result of the recent financial crisis, a significant number of companies will have to be restructured (including four major state banks) to avoid bankruptcy so that positive effects on state revenues, on employment and on the economy in general can be reached.

The Yen appreciation conditions may increase the direct capital investment to Indonesia from Japan and give Indonesian exporters more access to the Japanese market. On the other hand, the growing burdens of Indonesian debt services calculated in US Dollar that depreciated against the Yen hindered the government budgetary policy and the balance of payments. To counter these disturbances, Indonesia has to expand exports, economize the routine budget expenditures for keeping the resources to service foreign debt, negotiate with assisting countries to get more money for stabilizing the budget and the balance of payments.

Deregulation policies taken by the government since the mid 1980s for promoting export driven growth, encouraging foreign direct investment, modernizing financial and budgetary system, etc. are the reflections of the government ‘s intention to manage economic growth based on the market mechanism while many restriction still remain. There are still many unsatisfactory matters for development based on the development trilogy, that is, equity, justice and high economic growth.

B. Political circumstances

There were three political parties in Indonesia and Golkar was the biggest one since army forces, bureaucracy and big businesses had supported it but not the other two parties. Golkar has dominated The Legislative Assembly for more than 33 years not only at national level but also at local level. Due to Golkar superiority that was also backed up by the former President, “trias politica” did not work well. The general election conducted every five years seems like a game. Everybody knew which party was going to be a winner.

National elections in May 1997 provided little hope to those calling for a more open political system. During the campaign season the rumblings of discontent were the loudest, and most violent, in 25 years. The results of the parliamentary polls on May 29 were not surprising. Leaders of Golkar--the longtime ruling party backed by President Suharto, the military, and big businesses--had confidently predicted that the party would take just over 70% of the vote. Golkar won a record 74.4%. Golkar won 325 of the 425 seats being contested in the House of Representatives. Golkar's win virtually ensured that the new legislature would reelect Suharto to another five-year presidential term in 1998, but those who believed Suharto's style of government was out of touch with society remained disaffected.

The press that should be a partner for controlling government was just being shut up by many restrictions. During the New Order Government many newspapers and magazines were closed down by the Government. Presently, there are 48 parties and hundreds of newspapers and magazines in Indonesia. The current situation is very different. Now, the responses to the crisis are shaped by a range of political pressures and are also strongly influenced by the intellectuals, the press and political leaders and last but the most important of recent: the student’s movement.

So far, Indonesia's June 7, 1999 election seems free and fair despite instances of irregularities in several areas. This general election together with the presidential election that will be held in November 1999 would be critical milestones for Indonesia. A fair and clean election in Indonesia, which produces a government accepted by most Indonesians, would pave the way for political stability and investor confidence in the country.

There is still some political uncertainty over the elections. But, uncertainty is embodied in democracy. In my view, the political structures are in place now. The big plus for the country was that the main presidential candidates were all committed to a market-based economy. Thus the direction for the country is clear and economic reforms will continue. In fact, to make a directional shift away from the path would be impossible.

Indonesia's ruling Golkar party moved into second place as official counting in the June 7 parliamentary election crawled past the 70 percent as June 23, 1999. But Golkar, with 18.15 percent of the vote, still heavily trails populist Megawati Sukarnoputri's Indonesian Democratic Party-Struggle (PDI-P), which has 36.42 percent and is still favored to form a reformist coalition government. Many people had expected Golkar, tarnished by its links to ousted former President Suharto, to fare poorly in the first democratic election in more than four decades.

Analysts have warned of a violent public reaction if Golkar scores a strong showing or even manages to maintain power with he support of Islamic parties or the military. Until 23 June, 1999, Golkar had trailed the Nation Awakening Party (PKB) of Megawati's ally, Moslem leader Abdurrahman Wahid, which now has 18.12 percent of the vote. An unofficial tally by foreign advisers to the election commission of 75 percent of votes puts Golkar at 22 percent, PDI-P at 34 percent and PKB at 12 percent. Official counting is due to be completed by July 8.

## 2.6 Conclusion: Where We Stand and Where We Go

The new Indonesian government under Habibie has issued a new stabilization package intended to restore macroeconomic stability, rebuild the distribution system, strengthen the social safety net, and address the deteriorating condition of the financial system. Monetary policy focus on reducing inflation and facilitating an appreciation of the over depreciated exchange rate. The fiscal stance was eased to permit greater social expenditure and help stimulate economic activity.

Recent debates among the economists, business circles and administrative bodies on the economic distortions such as the monopoly, collusion or corruption, factors which are not defined objectively, expresses the effort of Indonesia to get out of the crisis and to develop again.

Due to economic development, structural problems and internal policies have significant influence on the prospect of the Indonesian economy, i.e., the quality of human resources and the condition of the labor market, the problems of distribution, quality of bureaucracy, real sector condition, industrial policy and structure, and the monetary and fiscal sector. But most of all, learning from Indonesian history, economic development can not coexist with the turmoil of extreme political instability. Indonesia once again must seek a meaningful and satisfactory way of addressing the political aspiration of its people while maintaining the stability needed to support economic development.

So far, current Indonesian economic situation still remains difficult until the political transition further advances. Firm implementation of the program and the expected continued strong financial support of the international community should allow for the restoration of positive real growth from 1999. Indonesia underscored the importance of ensuring transparency in program implementation, especially with regard to corporate and bank restructuring, and the need to avoid political interference in these processes. The new elected president must continue the policy framed by the IMF. A better political condition for reform should be established since it is so crucial to unleash new confidence in applying adjustment programs and to strengthen the country's medium-term growth prospects and its external position.

This economic crisis was compounded by political and social turbulence. The cycle of economic and political crises should be broken with the installation of the new government resulted by free and fair election. The new government should realize that prudent macroeconomic and fiscal discipline would be required to get the country back on track. Policies ensuring macroeconomic discipline should be strengthened and also a discipline exchange rate and monetary policy to provide transparency of the government operations.

Indonesian development can not rely on oil revenue anymore. However, oil was a mixed blessing. Further deregulation's were needed. The new reforms should be designed to let market forces reduce the dependence on oil and raise the competitiveness of Indonesian products on world markets. Tax and financial reforms were aimed at mobilizing government and private savings, while trade and investment reforms were aimed at unleashing the potential of the private sector. The process of structural adjustment should be accompanied by progress in reducing poverty. Due to crises, Indonesia has to control government expenses too.

The greatest legacy of these reforms is the increasing confidence that can be found in Indonesia today. Not to be the same country it was two years ago. Economically Indonesia has the capability to compete in the world markets of today and tomorrow. Socially and politically we have made progress toward our goal of an open, modern, dynamic, and democratic society.

Poverty is still a major problem and approximately 40 million people live below a poverty line that is only US $10 dollars per capita a month. Rapid economic growth and structural change are contributing to an increasing sense of inequity. The structure of Indonesian economy has long been dominated by relatively few major actors and their strength allowed them to move quickly when deregulation's were put in place. On the other hand the current banking system, infrastructure and government regulations do not provide a sufficiently supportive environment for small firms to develop. Across the country perceptions of inequity are rising as well. Infrastructure and human resources were relatively more developed in some regions than in others and these relatively better endowed regions have been able to take advantage of rising investment and growth opportunities. Thus, Indonesia continues to face many difficult challenges that will need to be addressed in the next phase of development.

Indonesia has come a long way over the past 32 years, and is still a low income developing country with half of our work force employed in traditional agriculture, still a long way to go. By the end of the second decade of the 21st century, Indonesia intends to become a middle income industrial nation, with one-third of Indonesia's GDP coming from manufacturing and less than 10% from farming. Indonesia aims to raise the average Indonesian income to approximately US$3,000 (in today's dollars). With a population approaching 260 million, Indonesian economy will be one of the largest in the world.

The reforms of the past decade have been aimed primarily at the private sector. Indonesian government now anticipates turning with equal energy and creativity to reforming incentives in the public sector. In the past Indonesian economy was simpler, the government directly controlled a larger share, and much of the rest was rural. However, the government's partnership with the private sector means that the government must provide them with efficient regulations and services. To do this, the government is planning for a substantial improvement in the way they deliver government services. The major thrust in this area will be to increase participation by decentralizing responsibility and decision making. In the globalization era the government must have the ability to make rapid and well-informed decisions, and these are best made by people who are familiar with the local situation.

In the era of open economies, falling costs of transportation and communications have vastly increased the level of global interaction and the flow of information. To take advantage of the opportunities this creates, Indonesia must adjust the economic incentives and rewards in its society so as to allow success at home and abroad. This requires a continuation and strengthening of the reforms of the past decade. With continued reform, Indonesia will be well on its way to achieving self-sustaining growth based on rising productivity and efficiency.

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