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like Pertamina (until its downfall) as vehicles to achieve these two objectives.²⁸ This position allies the technicians with members of the intelligentsia who see state enterprises as the way to counterbalance Chinese domination of the corporate sector.

The technicians' control of the Ministry of Trade has allowed them to encourage domestic production of manufactured goods, including airplanes. Given the strong sense of economic nationalism in Indonesia and the widespread belief that only industrialization (regardless of whether it is import-competing or export-oriented) holds the key to a higher standard of living, the technicians enjoy popular support among the Indonesian elite. Furthermore, their import-substitution industrialization has won them the support of the army, the most powerful constituency in the country. Thanks to the *dwifungsi* doctrine, the expansion of state enterprises translates directly into more managerial positions for senior military personnel. It must be noted that since most of the import-competing industries were set up in urban Java, the higher prices of manufactured goods represented an implicit tax on residents of the rural sector and the Outer Islands.

In looking at the political setting within which policies are chosen, we have identified an important political coalition of technocrats, Outer Islanders, and rural residents which favors a political package emphasizing the maintenance of a competitive exchange rate. The fact that there exists a strong institutional memory about the economically destructive effects of an overvalued exchange rate means that the government is naturally disposed to the arguments for a competitive exchange rate. Since a debt crisis occurs when a government runs out of foreign reserves, this emphasis on avoiding prolonged exchange rate overvaluation reduces the probability of a debt crisis by keeping the (foreign exchange earning) nonoil export sector healthy and capital flight low. We shall show in subsequent chapters how these political and economic factors have influenced the setting of economic policies and, hence, the performance of the economy.

4 The Fiscal System

4.1 Introduction

The two arguments we are developing in this monograph are that appropriate exchange rate management was fundamental to why a debt crisis did not appear during 1982–84 and that the exchange rate policy was heavily influenced by political considerations. The aim of this chapter is to test the

validity of the second argument by examining the fiscal system to see if its functioning is in accord with the political concerns to prevent impoverishment of the rural sector and to show equitable treatment of the main islands. We picked the fiscal system because it is largely controlled by the technocrats, and we have claimed in chapter 3 that the technocrats favor an economic strategy which has as its side effects (if not as its aims) the alleviation of rural poverty and the reduction of regional differences.

We will discuss the control and performance of the overall fiscal balance in chapter 7 where the subject of external debt management is explored in detail. A comparative analysis of external debt due to cumulated budget deficits is done in chapter 8. It is more natural to examine the accumulation of external debt due to fiscal deficits together with the management issues involved.

4.2 The Revenue Structure, 1969–83

In assessing the tax system before the December 1983 tax reform, it is important to keep in mind that the collection of taxes did not usually correspond closely to the tax laws. The shortage of competent personnel made enforcement of the highly complicated Indonesian tax code impossible. The result was “that the tax revenue targets published in the budgets determined the amounts which administrators felt obliged to collect” (Booth and McCawley 1981b, 136). Since the amount of taxes actually paid was nearly always a negotiated outcome, annual changes in income taxes bore little relation to the marginal tax rates. In short, the vertical and horizontal equity aspects of the income tax system cannot be accurately gleaned from the pre-1984 tax code. Furthermore, the tax burden owed to the state was consistently understated by the total amount of revenue collected. This is because of widespread petty corruption and occasional unauthorized levies on business transactions by administrative and military personnel.

The data in table 4.1 show the revenue structure of the central government, and they differ from the official classifications in three ways. Our total revenue figures from fiscal 1969 to fiscal 1971 are greater than the official figures by the amount of IPEDA because IPEDA was not included in central government revenue figures prior to 1972. (IPEDA stands for *Iuran Pembangunan Daerah* which means Contribution to Regional Development.) IPEDA is revenue which belongs to the provincial authorities and is collected on the provinces’ behalf by the central government. The “tax on nonoil income” category differs from the official definition in that it covers only personal income, corporate income, and withholding taxes; the “other taxes” subcategory under the official definition has been added to the “tax on nonoil domestic consumption” category in the table.¹ The third difference is that we have constructed a “tax from oil sector” category by combining official subcategories—the “tax revenue from oil corporations”

Table 4.1 Revenue Structure, FY1969 to FY1983 (in billions of Rupiahs)

	69/70	70/71	71/72	72/73	73/74	74/75	75/76	76/77	77/78	78/79	79/80	80/81	81/82	82/83	83/84
<i>Total revenue</i>	251.6	354.7	440.0	590.6	967.7	1,753.7	2,241.9	2,906.0	3,534.4	4,266.1	6,696.8	10,227.0	12,212.6	12,418.3	14,432.7
Tax on nonoil income	42.9	52.8	67.4	84.6	135.4	217.8	287.2	359.8	475.8	581.2	736.5	1,045.3	1,279.3	1,605.2	1,784.3
Tax on oil and gas	65.8	99.2	140.7	230.5	382.2	957.2	1,248.0	1,635.3	1,948.7	2,308.7	4,259.6	7,019.6	8,627.8	8,170.4	9,520.2
Tax on nonoil domestic consumption	50.8	61.8	72.5	92.1	133.3	184.3	253.6	328.9	432.1	534.7	599.0	811.1	986.7	1,266.5	1,560.3
Tax on international trade	81.0	117.8	119.9	133.7	247.5	299.8	308.1	421.3	481.7	587.0	843.0	948.1	887.9	835.4	916.0
Tax on property, IPEDA	8.0	10.0	12.0	15.1	19.5	28.0	34.6	42.2	52.5	63.1	71.4	87.2	94.5	105.2	132.4
Nontax receipt	3.1	13.1	27.5	34.6	49.8	66.6	110.4	118.5	143.6	191.4	187.3	315.7	336.4	435.6	519.5
<i>Share of total revenue (%)</i>															
Tax on nonoil income	17.1	14.9	15.3	14.3	14.0	12.4	12.8	12.4	13.5	13.6	11.0	10.2	10.5	12.9	12.4
Tax on oil and gas	26.2	28.0	32.0	39.0	39.5	54.6	55.7	56.3	55.1	54.1	63.6	68.6	70.6	65.8	66.0
Tax on nonoil domestic consumption	20.2	17.4	16.5	15.6	13.8	10.5	11.3	11.3	12.2	12.5	8.9	7.9	8.1	10.2	10.8
Tax on international trade	32.2	33.2	27.3	22.6	25.6	17.1	13.7	14.5	13.6	13.8	12.6	9.3	7.3	6.7	6.3
Tax on property, IPEDA	3.2	2.8	2.7	2.6	2.0	1.6	1.5	1.5	1.5	1.5	1.1	.9	.8	.8	.9
Nontax receipt	1.2	3.7	6.3	5.9	5.1	3.8	4.9	4.1	4.1	4.5	2.8	3.1	2.8	3.5	3.6
<i>Share of nonoil revenue (%)</i>															
Income tax	23.1	20.7	22.5	23.5	23.1	27.3	28.9	28.3	30.0	29.7	30.2	32.6	35.7	37.8	36.3
Domestic consumption tax	27.3	24.2	24.2	25.6	22.8	23.1	25.5	25.9	27.2	27.3	24.6	25.3	27.5	29.8	31.8
International trade	43.6	46.1	40.1	37.1	42.3	37.6	31.0	33.2	30.4	30.0	34.6	29.6	24.8	19.7	18.6
Property tax	4.3	3.9	4.0	4.2	3.3	3.5	3.5	3.3	3.3	3.2	2.9	2.7	2.6	2.5	2.7
Nontax receipt	1.7	5.1	9.2	9.6	8.5	8.4	11.1	9.3	9.1	9.8	7.7	9.8	9.4	10.3	10.6
<i>Indicative ratios (%)</i>															
Total revenue/GDP	9.3	11.0	12.0	12.9	14.3	16.4	17.7	18.8	18.6	17.8	19.5	20.9	20.9	19.8	19.6
Oil and gas tax/ GDP	2.4	3.1	3.8	5.1	5.7	8.9	9.9	10.6	10.2	9.6	12.4	14.4	14.8	13.0	12.9
Nonoil income tax/GDP	1.6	1.6	1.8	1.9	2.0	2.0	2.3	2.3	2.5	2.4	2.1	2.1	2.2	2.6	2.4
Property tax/GDP	.3	.3	.3	.3	.3	.3	.3	.3	.3	.3	.2	.2	.2	.2	.2
Nonoil income tax/ domestic consumption tax	84.4	85.4	93.0	91.9	101.6	118.2	113.2	109.4	110.1	108.7	123.0	128.9	129.7	126.7	114.4
Nonoil export tax/ total revenue	2.8	7.0	6.4	5.5	7.1	4.0	2.7	2.1	2.3	3.9	5.8	3.0	1.1	.7	.7
<i>Memo items</i>															
Tax on nonoil exports	7.0	25.0	28.1	32.7	68.6	70.3	61.6	61.7	80.2	166.2	389.1	305.0	128.4	82.5	104.0
Nominal GDP	2,718.0	3,238.0	3,672.0	4,564.0	6,753.4	10,708.0	12,642.5	15,466.7	19,033.0	24,002.5	34,344.7	48,913.5	58,421.3	62,646.5	73,697.6
GDP deflator (1980=100)	13.9	15.4	16.3	18.5	24.6	36.2	40.7	46.6	52.7	58.4	77.4	100.0	111.2	119.6	136.3

Note: New GDP series used from 1978 onward.

item from the direct tax category and the "other oil revenue" from the taxes on domestic consumption category. The second subcategory is zero after 1977/78 because the government stopped taxing the domestic use of oil and started subsidizing its use instead, changing what was formerly a revenue item to an expenditure item. Taxes on domestic consumption consist primarily of sales tax (which after 1984/85 includes value-added taxes) and excises. Prior to 1986 the property tax consisted only of IPEDA, the land tax. Nontax receipts are mainly the profits of state-owned enterprises.

The most notable feature of table 4.1 is the central government's increasing reliance on oil as its chief source of revenue. Oil revenue as a share of total federal revenue rose from 26 percent in 1969/70 to 55 percent in 1974/75, and peaked at 71 percent in 1981/82. The fiscal danger of such a narrow tax base was brought home dramatically in 1982 when the global recession caused oil prices to collapse. Oil revenue (in 1980 rupiahs) fell from Rp 7.8 billion in 1981/82 to Rp 6.9 billion in 1982/83, causing real total revenue to fall for the first time since the Soekarno years. The continued real revenue decline in the succeeding years as oil prices began their free fall from \$36/barrel to \$18/barrel wreaked havoc with the financing of expenditure, especially of development projects. It is, hence, only natural that since December 1983 the government has passed several tax reforms to broaden the tax base.

The need for action is well illustrated by the fact that nonoil revenue normalized by GDP has fallen from the 1969–71 average of 8 percent to the 1980–82 average of 6 percent. The fact that Indonesia was adhering to its balanced budget rule and the inflow of oil revenue had been enormous does not justify the decision to allow the tax base to shrink. The government could have broadened the tax base and still adhered to its balanced budget rule. All it had to do was reduce its foreign borrowing. Foreign borrowing obviated the introduction of unpopular measures to make tax collection broader and more effective. Since the ease of external borrowing was no doubt helped by the existence of substantial oil reserves, we can attribute the absence of base broadening largely to the two oil booms.

It appears that the "tax-negotiating" form of tax collection in the 1969–83 period did not undermine the spirit of progressiveness which the pre-1984 Indonesian tax code aspired to achieve. The fact that the nonoil-income-tax/GDP ratio exhibits a slow, rising trend indicates that the actual marginal rates are mildly progressive.

Indirect evidence suggests quite strongly that progressivity increased in the 1969–83 period. This statement is based on the common belief that direct income taxes are progressive and indirect consumption taxes are regressive. The Indonesian ratio of direct income tax to indirect consumption tax has been increasing over time. Income taxes were only 84 percent of consumption taxes in 1969/70, but averaged over 120 percent in 1980–83.

Indirect taxes increased more slowly than direct taxes as real per capita income doubled in the same period. It may be true that the rich did not pay the high taxes required by the tax code, but in light of the two preceding indicators of vertical equity, it cannot be said that this was done at the expense of the poor.

We are unable to analyze the incidence of taxes along rural-urban and regional divisions because the revenue data is not disaggregated enough to permit such an examination. There are two items in table 4.1, however, that permit us to make a partial assessment of our hypothesis that an agricultural bias existed in Indonesian fiscal policy. The first item is the ratio of IPEDA land tax to nonoil income tax which has shown a secular decline since 1969/70; IPEDA is paid almost entirely by landowners in rural areas, while income tax is paid by urban residents. This ratio, together with the increasing direct tax/indirect tax ratio, suggest that the tax burden in the rural sector has not increased at the same pace as in the urban sector.

The second item suggestive of agricultural sector bias is the large decline in revenue from nonoil export taxes (see memo item in the table) and from import taxes. As pointed out earlier, nonoil exports are largely agricultural products like rubber, palm oil, timber, coffee, tea, and spices. In April 1976 the export duties on most agricultural exports were reduced from 10 to 5 percent, and subsequently to zero. While there is no doubt that the large decline in export tax revenue is a big transfer to the agricultural sector, the almost equally dramatic phasing out of import taxes did not result in the same degree of transfer.² This is because the import tariff in some cases was replaced by nontariff barriers such as quotas and monopoly import licenses.

It is reasonable to believe that the government would not have allowed part of this import tax revenue to be transferred as economic rents to certain segments of the industrial elite if the treasury were not awash with oil revenue. This is the second instance of tax base erosion permitted by the oil boom, the first being the postponement of tax reforms because of easy external credit.

4.3 The 1984 Tax Changes and Their Aftermath

With the onset of the worldwide recession in 1982, there was an across-the-board fall in Indonesian exports. The severity of this external shock caused the real GDP growth rate to fall from 6.8 percent in 1981 to 0.1 percent in 1982. The oil sector was particularly badly hit, with oil export earnings plummeting from U.S. \$18 billion in 1981 to U.S. \$15 billion in 1982. Because oil taxes accounted for 70 percent of domestic revenue in 1981, the collapse in oil exports exerted severe financial pressures on government spending.³ The Indonesian government reacted swiftly against the financial crisis and the low level of economic activity: the rupiah was

devalued by 38 percent against the dollar in March 1983 to boost nonoil exports, and some forty-seven capital-intensive projects were postponed indefinitely.

It was clear that greater internal resource mobilization was necessary to make up for the immediate revenue shortfall and to broaden the tax base to prevent the reoccurrence of major financial crises arising from overreliance on one revenue source. There were a number of hopeful signs that a lot more revenue could be extracted from the nonpetroleum sector if better enforcement were undertaken. The most hopeful sign was that only 60 percent of the taxpayers who had filed returns in 1979/80 did so again the following year.

In December 1983 the Indonesian government announced a drastic revision of the personal and corporate income taxes which would take effect on 1 January 1984. The complicated and steeply progressive income tax structure was simplified to three rates—15 percent, 25 percent, and 35 percent—which applied to both personal and corporate taxpayers. To make enforcement easier, the cutoff point beyond which people had to pay income tax was doubled to render only 10 to 15 percent of the population eligible for income taxation. Greater attention was put on withholding as the way to collect personal income taxes. Corporations were required to withhold 15 percent of interest, rents, royalties, and dividends to domestic residents and 20 percent of these payments to foreigners. The time-consuming practice of collecting corporate taxes by negotiating individually with the firm concerned was replaced with complete self-assessments by the firms themselves. These self-assessments were subject to selective audit by the government to prevent abuses. The commitment to efficiency in the reform measures was emphasized by laying down specific time limits for the government to refund excess taxes and to respond to appeals against its rulings.

Later on in 1984 the Indonesian government sought to increase the tax rolls by announcing that taxpayers who registered by June 1985 were eligible for a pardon of past unpaid taxes. The broadening of the tax base was impressive—there were 995,000 registered income taxpayers at the end of 1985 compared to the 550,000 registered in March 1984. The tax amnesty program resulted in adding Rp 52 billion to 1985/86 revenue (IMF 1986a). It needs to be noted, however, that while the procedural reforms and simpler tax code reduced the administrative burden and the incentive to cheat, the biggest bugbear of the Indonesia tax system still remains: shortage of trained personnel. Until this outstanding personnel problem is resolved, nothing can be done about the fact that in 1985 only 50 percent of registered corporate taxpayers and 70 percent of registered personal-income taxpayers actually filed returns.

In April 1985 the complicated sales tax with seven different rates was replaced with a value-added tax (VAT) of 10 percent. Like the response to

the earlier income tax reforms, there was a surge in the number of registered VAT taxpayers—60,000 in December 1985, up from 25,000 in March 1985. The disappointing aspect, as with the income tax case, is that only 41 percent of the registered VAT payers are filing the required monthly returns. In January 1986 a new property tax law that consolidated IPEDA with six other property taxes was introduced and the stamp duty laws were revised.

The revenue-raising ability of the tax reform has been impressive (see table 4.2). Real nonoil income tax rose from 1.3 trillion rupiahs in fiscal 1983 to 1.7 trillion in fiscal 1986. The success of the VAT was even more impressive: it boosted the revenue from domestic consumption by 94 percent in the first year of its introduction. A further rise of 30 percent is expected

Table 4.2 Revenue Structure, FY1982 to FY1987 (in billions of rupiahs)

	82/83	83/84	84/85	85/86	86/87	87/88
<i>Total revenue</i>	12,418.3	14,432.7	15,905.5	19,252.8	17,832.5	17,236.1
Tax on nonoil income	1,605.2	1,784.3	2,121.0	2,313.0	2,880.5	3,315.9
Tax on oil and gas	8,170.4	9,520.2	10,429.9	11,144.4	9,738.2	6,938.6
Tax on nonoil domestic consumption	1,266.5	1,560.3	1,648.2	3,478.6	3,317.1	4,481.4
Tax on international trade	835.4	916.0	861.9	657.8	658.8	732.6
Tax on property, IPEDA	105.2	132.4	157.2	167.5	284.0	274.0
Nontax receipt	435.6	519.5	687.3	1,491.5	953.9	1,049.3
<i>Share of total revenue (%)</i>						
Tax on nonoil income	12.9	12.4	13.3	12.0	16.2	19.2
Tax on oil and gas	65.8	66.0	65.6	57.9	54.6	40.3
Tax on nonoil domestic consumption	10.2	10.8	10.4	18.1	18.6	26.0
Tax on international trade	6.7	6.3	5.4	3.4	3.7	4.3
Tax on property, IPEDA	.8	.9	1.0	.9	1.6	1.6
Nontax receipt	3.5	3.6	4.3	7.7	5.3	6.1
<i>Share of nonoil revenue (%)</i>						
Income tax	37.8	36.3	38.7	28.5	35.6	32.2
Domestic consumption tax	29.8	31.8	30.1	42.9	41.0	43.5
International trade	19.7	18.6	15.7	8.1	8.1	7.1
Property tax	2.5	2.7	2.9	2.1	3.5	2.7
Nontax receipt	10.3	10.6	12.6	18.4	11.8	10.2
<i>Indicative ratios (%)</i>						
Total revenue/GDP	19.8	19.6	18.2	20.0	17.6	16.0
Oil and gas tax/GDP	13.0	12.9	11.9	11.6	9.6	6.4
Nonoil income tax/GDP	2.6	2.4	2.4	2.4	2.8	3.1
Property tax/GDP	.2	.2	.2	.2	.3	.3
Nonoil income tax/ domestic consumption tax	126.7	114.4	128.7	66.5	86.8	74.0
Nonoil export tax/total revenue	.7	.7	.6	.3	.4	.4
<i>Memo items</i>						
Tax on nonoil exports	82.5	104.0	91.0	50.5	78.8	70.9
Nominal GDP	62,646.5	73,697.6	87,535.5	96,132.4	101,491.2	107,672.0
GDP deflator (1980 = 100)	119.6	136.3	152.6	165.8	170.9	176.0

Note: GDP deflator assumed to rise 3.1 percent in 1986 and 3 percent in 1987. Real GNP assumed to rise 2.4 percent in 1986 and 3 percent in 1987.

for fiscal 1987, increasing (real) consumption taxes by almost two and half times over their fiscal 1984 value.

The reduction of the maximum marginal rate from 50 percent to 35 percent did not decrease the progressiveness of the income tax system. Nonoil income taxes as a proportion of GDP rose from 2.4 percent in 1983/84 to 2.8 percent in 1986/87, and were expected to reach 3.1 percent in 1987/88. Progressiveness in income taxes was enhanced because the income tax reform greatly increased the number of people paying taxes. Furthermore, with the doubling of the threshold for tax eligibility, the majority of these new taxpayers are people who have incomes substantially above the average.

It seems however that the overall effect of the whole tax reform package may not be a progressive one. This is because the regressive taxes on nonoil domestic consumption (sales tax, VAT, excises, and stamp duties) were raised much more than progressive taxes on income. The ratio of income taxes to consumption taxes fell by 50 percent in fiscal 1985, the year that VAT was introduced.

4.4 The Structure of Central Government Expenditure

Table 4.3 shows the allocation of state expenditure according to function. Expenditure is divided into two categories: routine and development. Routine expenditure represents what is necessary to maintain the level of existing government services, while development spending represents capital deepening which expands the productive capacity of the economy.

In the case of Indonesia, the official designation of development expenditure does not in many instances correspond to its economic definition. The biggest misnomer is generally believed to be the payment of salary supplements from the development budget to government employees for development-related activities. There is great incentive for government workers to initiate many minor development projects because the average salary in the public sector is rather low and the criteria for supplement awards is quite broad. Salary supplements are paid to civil servants for engaging in "development" activities such as serving on the steering committee of a new project, doing exercises in project evaluation, and travelling to inspect construction projects. The result is that many members of the bureaucracy receive regular supplements which amount to significant portions of their salaries. The worst feature of this scheme is that it encourages neglect of operations and maintenance activities in favor of starting new projects.

Other items of routine expenditure that are included in the development budget are fertilizer subsidies and military expenditure. The former is clearly an input to the current production process, and the latter contributes to capacity creation only in the broadest sense that viable economic growth is

Table 4.3 Expenditure Structure of the Central Government Budget FY1969 to FY1987 (in billions of rupiahs)

	69/70	70/71	71/72	72/73	73/74	74/75	75/76	76/77	77/78	78/79
<i>Total expenditure</i>	342.7	467.8	557.0	736.3	1,164.2	1,977.9	2,730.3	3,684.3	4,305.7	5,299.3
<i>Total routine expenditure</i>	216.5	288.2	349.1	438.1	713.3	1,016.1	1,332.6	1,629.8	2,148.9	2,743.7
Personnel	103.8	131.4	163.3	200.4	268.9	420.1	593.9	636.6	893.2	1,001.6
Debt service	14.4	25.6	46.6	53.4	70.7	73.7	78.5	189.5	228.3	534.5
External debt service	12.7	23.6	37.2	44.1	62.6	67.3	71.7	165.1	220.9	525.7
Internal debt service	1.7	2.0	8.4	5.3	11.1	6.4	6.8	24.4	7.4	8.8
Subsidies to regions	44.1	56.2	66.8	83.9	108.6	201.9	284.5	313.0	478.4	522.3
Food subsidy	.0	.0	.0	.0	.0	141.0	50.0	39.0	.0	43.5
Oil subsidy	.0	.0	.0	.0	.0	.0	.0	.0	65.1	197.0
Other routine expenditures	54.2	75.0	72.4	100.4	265.1	179.4	325.7	451.7	483.9	444.8
<i>Total development expenditure</i>	126.2	179.6	207.9	298.2	450.9	961.8	1,397.7	2,054.5	2,156.8	2,555.6
Regional development	12.6	43.5	49.6	55.7	70.1	136.0	173.0	190.0	251.0	275.0
Fertilizer subsidy	.0	.0	.0	.0	33.0	227.2	134.0	107.0	32.0	83.0
Agriculture & irrigation, excluding fertilizer subsidy	25.0	32.1	46.6	39.6	45.0	74.8	123.0	249.0	348.0	367.0
Industry & mining	5.8	1.8	8.1	4.7	5.3	71.0	124.0	195.0	139.0	205.0
Electric power	4.1	7.1	14.1	16.2	21.6	79.0	128.0	218.0	223.0	272.0
Transportation, tourism & communications	25.3	17.7	42.4	44.0	57.0	124.0	312.0	429.0	355.0	413.0
Manpower & transmigration	.1	1.0	.7	.3	.0	5.0	12.0	27.0	61.0	95.0
Education & culture	9.1	8.9	10.9	16.2	29.9	47.0	114.0	136.0	211.0	251.0
Health & social welfare	4.5	3.5	4.6	7.3	14.4	25.0	38.0	48.0	71.0	79.0
Housing & water supply	1.2	2.6	2.4	4.4	5.3	7.0	13.0	30.0	90.0	56.0
General public services	11.8	14.6	11.9	16.0	78.0	49.0	72.0	114.0	123.0	225.0
Government capital participation	.0	1.0	7.0	24.7	.0	98.0	115.0	225.0	190.0	162.0
Other items	.9	1.2	1.6	1.9	.0	19.0	40.0	87.0	63.0	73.0
Unknown allocation of project aid	25.8	44.6	8.0	67.2	91.3	.0	.0	.0	.0	.0
<i>Memo item</i>										
GDP deflator (1980 = 100)	13.9	15.4	16.3	18.5	24.6	36.2	40.7	46.6	52.7	58.4

(continued)

Table 4.3 (continued)

	79/80	80/81	81/82	82/83	83/84	84/85	85/86	86/87	87/88
<i>Total expenditure</i>	8,076.0	11,716.1	13,917.6	14,355.9	18,311.0	19,380.8	22,824.6	21,421.6	23,583.2
<i>Total routine expenditure</i>	4,061.8	5,800.0	6,977.6	6,996.3	8,411.8	9,428.9	11,951.5	13,125.6	15,826.6
Personnel	1,419.9	2,023.3	2,277.7	2,418.1	2,757.0	3,046.8	4,018.3	4,212.6	4,316.9
Debt service	684.1	784.8	931.0	1,224.5	2,102.7	2,776.5	3,323.1	4,223.2	6,805.4
External debt service	647.6	754.0	915.0	1,204.7	2,072.9	2,737.2	3,303.1	4,183.2	6,765.4
Internal debt service	36.5	30.8	16.0	19.8	29.8	39.3	20.0	40.0	40.0
Subsidies to regions	669.9	976.1	1,209.4	1,315.4	1,546.9	1,883.3	2,489.0	2,639.7	2,649.1
Food subsidy	124.9	281.6	224.0	1.0	.0	0.0	.0	.0	.0
Oil subsidy	534.9	1,022.0	1,316.0	962.0	928.1	506.7	374.2	142.4	.0
Other routine expenditures	628.1	712.2	1,019.5	1,075.3	1,077.1	1,215.6	1,746.9	1,907.7	2,055.2
<i>Total development expenditure</i>	4,014.2	5,916.1	6,940.0	7,359.6	9,899.2	9,951.9	10,873.1	8,296.0	7,756.6
Regional development	336.0	482.0	616.0	711.0	749.0	791.0	850.0	939.0	873.1
Fertilizer subsidy	85.0	283.0	371.0	420.0	324.0	732.0	477.1	672.0	203.5
Agriculture & irrigation, excluding fertilizer subsidy	423.0	646.0	583.0	511.0	589.0	967.0	660.9	434.0	977.2
Industry & mining	356.0	491.0	827.0	913.0	2,153.0	839.0	1,189.0	737.0	349.9
Electric power	376.0	431.0	530.0	758.0	660.0	911.0	1,447.0	788.0	1,008.9
Transportation, tourism & communications	466.0	780.0	807.0	876.0	1,527.0	1,428.0	1,484.0	1,063.0	1,288.1
Manpower & transmigration	162.0	326.0	417.0	436.0	456.0	422.0	665.0	394.0	156.6
Education & culture	362.0	575.0	726.0	703.0	1,032.0	1,231.0	1,413.0	1,146.0	1,021.5
Health & social welfare	142.0	218.0	286.0	259.0	279.0	320.0	398.0	312.0	207.7
Housing & water supply	117.0	191.0	166.0	151.0	221.0	224.0	335.0	333.0	412.0
General public services	473.0	700.0	800.0	785.0	899.0	927.0	977.0	722.0	569.4
Government capital participation	466.0	389.0	389.0	281.0	234.0	292.0	221.0	202.0	191.1
Other items	250.0	404.0	422.0	556.0	776.0	868.0	758.0	554.0	497.0
Unknown allocation of project aid	.0	.0	.0	.0	.0	.0	.0	.0	.0
<i>Memo item</i>									
GDP deflator (1980 = 100)	77.4	100.0	111.2	119.6	136.3	152.6	165.8	170.9	176.0

not possible without deterrence of foreign aggression. In the absence of more information, it is not possible for us to eliminate the discrepancy between the official and economic definitions of development expenditure.

The allocation of official development expenditure by program is given in table 4.4. The general INPRES programs are funds channelled to local authorities to finance public works projects chosen at their own discretion. The INPRES village program was started at the very beginning of the Soeharto era to alleviate rural unemployment and to rebuild the rural infrastructure that had been allowed to deteriorate under Soekarno. With the growth of the oil sector in the early 1970s, the INPRES district and province programs were started partly to handle projects which affected more than one village and, partly, because the village administrators were not able to absorb more funds. This decentralized decision making in the public works projects of the general INPRES programs is very much in line with what we have earlier identified to be one of Soeharto's traits—impatience with the bureaucracy. While efficiency was clearly an important concern, what may have been equally important was the political symbolism of commitment to rural development.

With the increased inflow of oil revenue, sectoral INPRES programs in primary education, health, reforestation, market and road construction were started and funding to existing INPRES programs was increased. In real terms (1980 prices), the cost of INPRES programs rose from Rp 276 billion in fiscal 1973 to Rp 714 billion in fiscal 1980. The government also expanded its industrialization program: annual government capital participation rose from Rp 166 billion to Rp 477 billion in the same period, a 16 percent annual rate of increase. Given the easing of the budget constraint, it was only natural that subsequent spending was much broader in coverage.

4.5 Preferences as Revealed by the Expenditure Pattern

In the discussion on political considerations in chapter 3, we identified a goal of the Soeharto government to be the improvement of the livelihood of the Javanese peasants. This goal is based on the fear of the reemergence of the PKI in its traditional rural stronghold. It must be emphasized that the logical policy translation of this primary policy concern is to reduce rural poverty and not the degree of rural-urban inequality. The policy emphasis is on the *absolute* standard of living rather than on the *relative* standard of living.

Given the history of separatist movements and the fact that the Javanese dominated key government positions, we also identified regional equity to be another of Soeharto's primary political concerns. The policy translation in this case is the attenuation of differences in the standard of living across islands. Finally, we argued that the technocrats, because of their belief in comparative advantage, would strive to maintain and improve the economic

Table 4.4 Distribution of Development Expenditure by Programs FY1972 to FY 1987 (in billions of rupiahs)

	Actual														Budget	
	72/73	73/74	74/75	75/76	76/77	77/78	78/79	79/80	80/81	81/82	82/83	83/84	84/85	85/86	86/87	87/88
1. Departments	150.0	167.3	221.6	384.9	590.9	744.5	851.0	1,480.3	2,533.2	2,724.6	3,260.9	3,219.5	3,474.4	4,466.5	2,087.7	752.2
2. General INPRES programs	39.3	48.7	101.3	129.0	143.7	167.7	181.6	218.8	336.8	448.1	535.3	538.8	540.4	574.5	599.7	604.9
Subsidies to provinces	20.8	20.8	47.4	54.0	61.5	75.4	86.8	100.7	166.7	215.0	253.0	253.1	253.0	287.3	280.0	280.0
Subsidies to <i>kabupatens</i>	12.8	19.2	42.5	59.1	62.4	69.1	70.9	87.1	119.4	162.6	193.9	194.1	194.6	188.6	220.8	226.0
Subsidies to villages	5.7	5.7	11.4	15.9	19.8	23.2	23.9	31.0	50.7	70.5	88.4	91.6	92.8	98.6	98.9	98.9
3. Sectoral INPRES programs	.0	19.2	25.0	65.1	94.1	137.0	176.0	252.0	377.2	584.5	444.2	771.2	824.4	753.7	715.5	326.3
Primary schools	.0	17.2	19.7	49.9	57.3	85.0	111.8	155.8	249.8	374.5	267.4	549.3	572.0	526.1	417.2	100.8
Health	.0	.0	5.3	15.2	20.8	26.3	26.9	30.0	50.4	78.8	80.3	87.3	64.6	110.6	114.5	76.3
Markets	.0	.0	.0	.0	.0	1.2	1.3	12.4	2.5	6.0	4.5	10.6	25.5	4.4	11.5	3.0
Replanting/ afforestation	.0	.0	.0	.0	16.0	24.5	36.0	40.8	48.6	70.4	49.6	59.4	61.2	42.5	42.3	16.2
Roads	.0	.0	.0	.0	.0	.0	.0	13.0	25.9	54.8	42.4	64.6	101.1	70.1	130.0	130.0
4. IPEDA	15.2	19.5	28.0	34.6	42.2	52.5	63.1	71.4	87.2	94.5	105.2	132.4	157.2	167.5	255.6	246.6
5. Irian Jaya and East Timor	3.3	3.3	4.0	5.5	5.0	9.0	10.4	6.6	6.4	6.8	5.7	5.2	4.2	6.9	7.2	5.0
Subtotal of transfers to lower levels of government (2-5)	57.8	85.7	158.3	234.2	285.0	366.2	431.1	548.8	807.6	1,133.9	1,090.4	1,447.6	1,526.2	1,502.6	1,578.0	1,182.8
6. Fertilizer subsidy	.0	33.0	227.2	134.5	107.3	31.8	82.6	125.0	283.6	371.4	420.1	324.2	731.6	477.1	671.5	203.5
7. Government capital participation (PMP)	22.5	40.8	91.1	108.7	217.9	166.9	128.5	252.8	476.5	480.9	336.6	591.7	336.1	412.3	207.4	83.4
8. Others	5.6	10.0	67.7	64.0	79.8	109.8	75.1	291.0	385.5	565.3	326.7	448.7	474.9	511.2	243.7	109.0
Total (1-8)	235.9	336.3	765.9	926.3	1,280.9	1,419.2	1,568.3	2,697.9	4,486.4	5,276.1	5,434.7	6,031.7	6,543.2	7,369.7	4,788.3	2,330.9
9. Project aid	62.3	114.1	195.9	471.4	773.6	737.6	987.3	1,316.3	1,429.7	1,663.9	1,924.9	3,867.5	3,408.7	3,503.4	3,507.7	5,425.7
Total (1-9)	298.2	450.9	961.8	1,397.7	2,054.5	2,156.8	2,555.6	4,014.2	5,916.1	6,940.0	7,359.6	9,899.2	9,951.9	10,873.1	8,296.0	7,756.6

incentives to produce Indonesia's traditional exports, primary commodities. Since the production of primary commodities is confined to rural Java and the Outer Islands, the thrust of the technocrats' economic program addresses two important political objectives of the government.

It is impossible to conclude from tables 4.3 and 4.4 whether a rural bias exists because only a few of the items in them can be easily classified either as pro-rural or pro-urban. The obvious pro-rural items are "fertilizer subsidy" and "agriculture and irrigation" in table 4.3 and most of the INPRES programs in table 4.4. The obvious pro-urban items are "food subsidy" and "housing and water supply" in table 4.3. Examination of these items shows that the pro-rural items tended to be financed first after the 1973 and 1979 OPEC price increases, and that they also tended to suffer smaller cuts when future revenue prospects turned gloomy as in 1977/78 and 1983/84.

The 1986/87 fertilizer subsidy allocation provides a striking example of rural income maintenance. In the 1986/87 recession, while total nominal spending by the government fell by 7 percent in response to lower domestic revenue, fertilizer subsidies actually rose by 20 percent in an attempt to check the fall in rural Javanese income. What is really noteworthy about this is that the peasants were encouraged to grow more rice at a time when BULOG, the state rice agency which guarantees the floor price, was on the verge of bankruptcy because of the runaway costs of storing the excess rice from the bumper harvests of previous years!

Another indication that the commitment to rural development is genuine is that the first two programs started right after the 1973 oil price increase were targeted toward the rural sector. Fertilizer subsidies benefited the agricultural sector directly, and the first sectoral INPRES program, by focusing on primary schools, benefited the rural sector disproportionately.

The fact that food subsidies, which benefited urban residents disproportionately, were started in 1974/75 after the 1973 oil price increases does not overturn our hypotheses of rural bias in government policies. The history of food subsidies clearly shows the lack of a systematic urban bias. Food subsidies were considered dispensable. During 1977/78 when Pertamina needed a cash infusion of Rp 86.4 billion to meet its debt obligations, food subsidies were eliminated that year. With the weakening of oil prices in 1982, food subsidies were drastically reduced in 1982/83 and completely ended in 1983/84.

Table 4.5 ranks the provinces by their nonmining regional gross domestic product (RGDP) and details the amount of central government expenditure under each program by province.⁴ Despite several sizable deviations, the central feature is that government outlay systematically varied inversely with the income of the province. The average total central government spending for the poorest one-third of the regions is 26 percent of RGDP, for the middle one-third, 21 percent, and for the richest one-third, 17 percent.⁵

Table 4.5 Per Capita Budgetary and Central Government Direct Development Expenditures 1980/81

Province	1980 Nonmining RGDP Per Capita (in thousands Rp)	INPRES Grant Rp/cap	Central Subsidy Rp/cap	Central Development Expenditure Rp/cap	Total Spending & Nonmining RGDP
South East Sulawesi	87	13,523	10.177	36,618	72
West Nusa Tenggara	97	5.692	6.536	10.342	23
East Nusa Tenggara	97	5.704	11.406	9.805	27
D.I. Jogjakarta	119	4.697	9.084	10.801	22
Central Java	127	2.830	6.305	4.967	11
West Java	131	3.015	6.353	8.176	13
Lampung	146	4.629	7.038	8.293	13
Jambi	146	9.497	7.541	26.864	30
East Java	147	3.022	5.479	4.902	9
Central Sulawesi	147	10.896	8.973	20.110	27
Bengkulu	148	14.185	8.106	34.319	38
West Sumatra	153	5.653	7.563	17.400	20
Bali	153	6.889	8.220	12.288	18
Aceh	157	6.849	8.069	19.467	22
South Sulawesi	158	4.968	7.045	9.754	14
West Kalimantan	168	8.339	8.267	12.754	17
South Kalimantan	181	7.804	10.266	22.712	23
North Sulawesi	196	7.920	13.609	16.364	19
Irian Jaya	197	11.365	27.197	28.016	34
North Sumatra	205	5.034	8.530	10.908	12
Maluku	223	8.801	8.998	16.275	15
South Sumatra	228	6.507	5.276	18.131	13
Riau	250	7.292	10.187	23.557	16
Central Kalimantan	270	13.075	11.359	21.794	17
DKI Jakarta	448	2.042	6.690	94.031	23
East Kalimantan	740	10.431	10.431	25.354	6
Indonesia	167	4.465	7.111	9.961 ^a	13

Source: World Bank (1984, 133).

^a Excluding DKI Jakarta. The figure including Jakarta is 13.661. The high figure for Jakarta reflects the substantial level of spending on the apparatus of the Central Government rather than on the development of Jakarta itself.

Examining the big outliers to the practice of awarding more aid to the poor provinces yields a very interesting finding. Four Javanese provinces—Jogjakarta, Central Java, West Java, and East Java—rank fourth, fifth, sixth, and ninth in terms of poverty, yet only Jogjakarta received aid higher than the average level of 13 percent. In Jogjakarta's case, its higher aid level may have less to do with its poverty than with the fact that its sultan played an important role in Soeharto's rise to power (he was Soeharto's first vice president). East Java's RGDP is indistinguishable from those of Lampung, Jambi, Central Sulawesi, and Bengkulu, but its aid level is only 9 percent while the others receive 13 percent, 30 percent, 27 percent, and 28 percent, respectively.

We interpret this Outer Island bias as a deliberate attempt to lessen the seemingly big differences in the absolute amount given to each island. As it is, three Javanese provinces (Central Java, West Java, and East Java) already account for Rp 119 billion of the total amount of Rp 313 billion spent, i.e., 38 percent. If Jakarta and Jogjakarta are included, then Java is receiving 61 percent of total budgetary transfer and direct development expenditures while contributing only 47 percent to total national income. It was, apparently, necessary to tolerate inequities toward these three Javanese provinces in order to have some semblance of regional (inter-island) equity. The political message of table 4.5 is clear: the top echelon of the Soeharto government may be dominated by Javanese, but the government is committed to improving the standard of living in the Outer Islands. This political message is the legacy of the many secessionist movements in the 1950s and early 1960s.

Table 4.6 focuses on a number of welfare measures in order to provide an alternate way of determining the thrust of Indonesian economic policy, especially its fiscal policy. We have limited the welfare measures to those which particularly apply to the poorest segment. This is because the provision of services to meet the basic needs of the poor is heavily dependent on government expenditure. Part A of the table divides the population along rural-urban lines. In 1971 only 58 percent of rural children aged seven to twelve attended school compared with 73 percent among urban children. In 1980 the figures were 81 percent and 90 percent, respectively. In the same period the ratio of rural to urban infant deaths declined from 5.5 to 4.6. The surprising finding here is that the rural poor may actually eat better than the urban poor, 1,471 calories per day in the rural sector as against 1,433 in the urban sector. Together, these three basic-needs indicators paint a picture of improvement in the social services being provided in the countryside and imply that the Indonesian government does not neglect the rural population.

Part B of table 4.6 provides a number of regional welfare measures to serve as a consistency check on the conclusions drawn from table 4.5. The most notable difference is that the provision of health care in the Outer Islands appears to be more pervasive. The minimum average number of health centers in the Outer Islands is at least one and a half times more than in Java. The basic health conditions appear to be at least as good in the Outer Islands as in Java; the infant mortality rate and life expectancy are almost indistinguishable across the main islands, except for the Eastern Islands.

The primary school enrollment also saw uniform improvements—a 33 percent improvement in every region. It is clear that the expenditure of the INPRES primary school program was quite evenly spread among the islands. Perhaps the same could be said about the regional division of government programs in general because the poverty rate fell by approximately 17 percentage points in both Java and the Outer Islands.

Table 4.6 Indicators of Distribution of Government Expenditures on Basic Needs

Part A: Rural-Urban Equity						
					1971	1976
Ratio (rural/urban) of number of infant deaths					5.5	4.6
School enrollment ratio for 7–12 year olds						
Rural					51	81
Urban					73	90
Daily calorie intake among the poorest 40 percent of sector in 1976					Rural 1,471	Urban 1,434
Part B: Inter-Island Equity						
	<i>Indonesia</i>	<i>Java</i>	<i>Sumatra</i>	<i>Kalimantan</i>	<i>Sulawesi</i>	<i>Eastern Islands</i>
Health centers per million people 1980	32	24	36	71	48	50
Infant mortality rate						
1971	140	138	139	139	149	NA
1980	105	104	93	106	108	NA
Life expectancy						
1969	46.7	47.1	47.0	46.8	45.2	42.7
1978	52.9	53.1	55.4	53.8	52.3	47.8
(years increase)	(6.2)	(6.0)	(8.4)	(7.0)	(7.1)	(5.1)
Primary school enrollment ratio						
1971	60	59	64	60	62	63
1980	84	85	84	77	82	84
Poverty rate	<i>Indonesia</i>	<i>Java</i>	<i>Outer Islands</i>			
1970	57	65	43			
1980	40	47	28			
Per capita consumption index, Indonesia = 100						
1970	100	88	130			
1980	100	97	105			

4.6 A Summing Up

The examination of the fiscal system supports our claim that the technocrats favor an economic strategy which leads to resource transfers to the Javanese hinterland and to the tree crop industries in the Outer Islands. The secular decline in trade taxes and low taxation of land relative to income reflect Soeharto's political concern with communism and secession, as well as the technocrats' neoclassical inclination toward the comparative advantage doctrine. This favorable tax treatment of the agricultural sector improves the rural-urban terms of trade and hence encourages the production of tradables, the presence of which determines a country's ability to service its debts.

In examining government expenditure, we surmised from fragmentary evidence that government spending was more likely to display a rural rather than an urban bias. In the absence of more detailed data, disproportionate weight was given to the budget allocations for fertilizer subsidies, irrigation projects, rural school programs, the INPRES village programs, and food subsidies. Because of better data, stronger evidence could be garnered to support the hypothesis that budget allocations were more sensitive to inter-island equity. There is in fact evidence that inter-island equity takes precedence over rural-urban equity. This is consistent with our conjecture that the concern for rural development stems more from a desire to eradicate poverty than to narrow the rural-urban gap.

The analysis of this chapter sets the stage for our forthcoming discussion on the importance of political factors in determining the debt outcome. To the extent that people are consistent in their actions, the fact that the technocrats support, and Soeharto approves of, a fiscal policy which favors the tradable sector means that they would also advocate a similarly-oriented exchange rate policy. We will show in chapter 6 that exchange rate management has been tempered by political considerations, and will quantify in chapter 8 that this exchange rate policy resulted in Indonesia avoiding a debt crisis during 1982–84.

5 Monetary Policy and Financial Structure

5.1 Introduction

The purpose of this chapter is to analyze the conduct of monetary policy and the development of the financial sector since 1966. Along with other economic measures, financial policies have been actively used by the government to pursue its macroeconomic objectives. During the period of prosperity in the 1970s, mainly due to the two oil booms in that decade, there was no incentive for the government to reform the underdeveloped tax and banking systems which were inherited from the Dutch colonial administration. Major reforms to the financial system in order to mobilize domestic saving were initiated only after the bust of the second oil boom. In contrast to the 1966–67 reforms which accomplished a total turnaround of the economy in a relatively short period of time, recent reforms cannot produce quick results.