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FINANCING ECONOMIC DEVELOPMENT IN INDONESIA

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The Problem: Financial Resources and Capital Requirements

I do not belong to the school of pessimists who consider that underdeveloped countries such as Indonesia are necessarily hampered by an absolute shortage of domestic fiscal and financial resources for development. Nor do I believe that it need be conceded that foreign investment or foreign aid must provide the bulk of financial resources to support a domestic development program. Compared to many underdeveloped countries, Indonesia has extensive natural resources and unutilized factors of production which could be combined to increase output if mobilization of financial resources to provide the complementary capital could be accomplished.[2] It is indeed true that the present rates of savings and capital formation in Indonesia are realtively low; although not nearly so low as we have been led to believe. The thesis which I wish to develop is that latent sources

1. This is a revised draft of a paper originally presented at a joint Indonesian Embassy-Center for International Studies meeting on December 21, 1954.

2. Since discussion centers here on mobilization of financial resources, the problem of transforming financial resources into real capital will not be explored. The transformation process may in fact be a more intractable economic problem in the short run than mobilization of financial resources.

of financial resources do exist, and given proper institutional evolution and an aggressive program of action, these domestic resources could be mobilized to contribute to a fruitful development plan.

Repeatedly economists have been frustrated by their wrong prognostications about the potentialities of financing developmental investment in underdeveloped economies. Frequently these prognostications are made on the basis of observed rates of savings and investment. The observed rates appear so low that increasing investment adequately to maintain, much less increase, per capita income where rapid population growth is now taking place seems to be a virtually impossible task without substantial external aid. Recent experience in countries where violence has been done to traditional institutional structures which stood in the way of mobilizing existent and potential resources, however, demonstrates that the matter of financing is not necessarily a major obstacle to development. The recent history of economic growth in India and on Mainland China provide illuminating examples of this argument.

Recent research in Indonesia is beginning to reveal that a considerably higher rate of net investment takes place than that reported in existing estimates. Although investment may not flow into channels leading to maximum rates of growth prior to the beginning of a development program, it nevertheless represents the existence of resources

which could conceivably be diverted to developmental investment without great reductions in the level of current consumption. We will also attempt to demonstrate that adding to the current rate of investment by providing domestic financing may go far towards meeting the capital requirements of a program for increasing _per capita_ output in Indonesia.

There appear to be margins of taxable capacity in particular sectors of the economy which could be reached to provide real savings from the present patterns of output and consumption. Moreover, it is clear that both idle and under-employed resources exist within the present economic framework. Although more effective combination and utilization of existing factors may indeed present formidable problems, it should be recognized that their present state of utilization provides an eventual resource pool for accelerating the rate of investment as a development program gets under way. However, a steady flow of foreign capital will undoubtedly be required to supplement domestic financial resources if Indonesia is to make a take-off into sustained economic growth.

Unfortunately there is little analysis available to provide reliable estimates of the amounts of capital required to achieve given economic objectives in Indonesia. Dr. Eugene Grasberg, however, has done pioneering research in this area in his recent papers

on Indonesia's capital requirements.[3] Utilizing the data made available by Dr. Neumark's national income study and other Indonesian materials, Dr. Grasberg has estimated the order of magnitude of annual investment required to achieve a number of major economic goals. These goals are:

1. Maintenance of per capita supplies of all goods and services at 1954-1955 levels;

2. Eliminating import of food and reducing fiber imports by 25 per cent within five years;

3. Avoidance of balance of payments deficits and rebuilding the country's foreign exchange reserves;

4. Compensating in domestic production, over a five year period, for one-half of the reduction in non-food essential imported goods which has occured during the recent years of retrenchment; and

5. increasing per capita consumption of all goods by two per cent per year.

According to Grasberg's calculations, maintenance of per capita supplies of all goods and services at 1954-1955 levels, in the face of estimated population growth of 1 1/2 per cent per annum, would

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3. Eugene Grasberg, Indonesia's Investment Requirements, Center for International Studies, Document Control #C/54-9, and Indonesia's Investment Requirements (Revised), Center for International Studies, Document Control # E/55-20.

require net annual investment (in 1956) totalling approximately Rp. 5.3 billion. If objectives 1 and 4 (elimination of food imports and reduction of fiber imports by 25 per cent in five years and compensating for one-half of recent import reductions) are added, total net investment requirements for 1956 would rise to approximately Rp. 6.6 billion. For the four years after 1956, investment required to raise output enough to meet these objectives would rise slightly as depreciation allowances rose _pari passu_ with investment; however, after five years, objectives 1 and 4 would be realized and investment requirements might therefore fall by about Rp. 1.3 billion.[4]

If, however, the objectives included, in addition, raising per capita consumption of all goods and services by 2 per cent per year, required net investment outlay would rise steeply to approximately Rp. 13 3/4 billion for 1956, Rp. 14 billion for 1957, Rp. 14 1/8 billion for 1958, Rp. 14 1/3 billion for 1959 and Rp. 14 1/2 billion for 1960.[5]

Sources of Finance: The Balance of Payments

I would now like to turn to the question of mobilizing the financial resources for a development program of roughly this order of magnitude. My research has led me to believe that a large part of

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4. Eugene Grasberg, _Indonesia's Investment Requirements_ (Revised), Table 6.

5. _Ibid_

the financial resources needed to meet these capital requirements could be found domestically. But it is also my belief that these resources, in the short-run at least, should be transferred to the government for investment through the fiscal system rather than by net additions to the income stream in the form of newly created money. To establish these propositions, let us consider briefly the three potential areas through which financial resources for development could conceivably be mobilized.

First of all, we might consider the feasibility of extracting financial resources from the economy through promotion and regulation of foreign trade. The Balance of Payments could provide an effective channel if it were possible to provide a surplus in the current account to build up a supply of savings in the form of foreign currencies.[6] Effective utilization of such resources would of

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6. It should be pointed out that Balance of Payments Controls may be used, like other methods, to mobilize from the economy financial resources (savings) for investment. The existence of a surplus in current account would not, however, in and of itself, be a sufficient condition for producing such investment, or, in fact, for producing savings. All that is suggested here is that, with complementary policies, the existence of a surplus in the current account could serve as a source from which financial resources for development could be squeezed. This might be achieved, for example, by employing a "tax" on foreign trading operations designed to limit the level of imports, thus inducing forced savings made available by appropriate devices to the government, or to entrepreneurs to whom it chooses to transfer these resources. Such savings would differ from voluntary domestic savings not so much by nature as by the means by which they would be mobilized. In the case of savings mobilized through control of foreign trade, domestic savings would be forced by limiting the supply of import goods for general domestic consumption.

course necessitate the use of further devices to insure that the savings thus developed could be channeled into the kind of investment which the Indonesian development program would call for. However, analysis of Indonesia's recent Balance of Payments indicates that prospects for mobilizing financial resources through this medium are not very bright, at least in the immediate future. An important characteristic of post-independence Balance of Payments has been a high level of liabilities in the invisible account. These items comprise relatively fixed obligations which cannot be reduced in any given year or even during a period of years in the near future. The main items have been transfers representing income on investment and costs of foreign technicians (including pensions for previous civil servants) of which a substantial part has been set in treaty agreements with Holland. A survey of Indonesia's Balance of Payments for 1953 will emphasize the nature of the problem; in that year the reported value of commodity exports amounted to approximately Rp. 7.7 billion compared to imports of about Rp. 7.2 billion. If proceeds from export duties are deducted from the value of commodity exports, however, commodity account shows a deficit of one-half billion rupiah. On the other hand, the deficit on the invisibles account amounted to Rp. 2 billion and the debit balance of long-term capital items approximated one-fourth billion rupiah. Thus the total Balance of Payments deficit was equal to approximately two and three-fourths billion rupiah. Hence,

if savings were to be mobilized through the Balance of Payments, a commodity export surplus would have to be produced to overcome what now appears to be a relatively permanent deficit in the invisibles account. The other alternative, of course, would be further reductions in the level of imports; here again, prospects appear to be rather dubious. Indonesia has already followed a strictly enforced policy of import controls, reducing imports to what I believe is near a minimum level consistent with the present level of production in the economy. In 1954 imports consisted mainly of food and other necessities, raw materials to maintain Indonesian production and capital goods to provide maintenance of Indonesia's productive resources intact. As we will argue below, these facts emphasize the need for foreign capital to meet at least an important part of the import component of a development program.

However, in the longer run there may be some hope of achieving a level of exports adequate to mobilize financial resources for development from foreign trading operations. This result, in the last analysis, depends both on increasing the present level of exports and holding the line on - or reducing - the level of imports. The latter presumably is dependent on increasing domestic output of goods now imported. During the last three months of 1954, prices of rubber and other agricultural exports rose significantly, and export earnings in 1954 are reported to have exceeded the 1953 level by Rp. 200

million. Since imports have been cut by Rp. 800 million below the 1953 level the effective 1954 current account deficit is estimated to be only Rp. 500 million.[7] These results have been achieved in part through diverse and sometimes discriminatory export promotional policies which appear to have increased the volume of exports over the 1951 and 1952 levels. However, during this period, the recovery of exports from agricultural estates, which has taken place in spite of rather than as a result of government policies, has been the major factor in the slow growth of exports. In the longer run, there is no question but that a development program itself will add to Indonesia's capacity to earn through exporting. However, it should be emphasized that significantly increased export earnings will depend on technological improvements providing for, among other things, industrial processing of agricultural raw materials. Such improvements can only be obtained by increased investment in this particular sector. The results of this investment will appear after a rather lengthy gestation period and will be hampered by relatively high capital-output ratios. Thus in the short run, financing of Indonesian economic growth of the required magnitude will have to come mainly from other sources.

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[7]National Planning Bureau "Indonesia's Economic and Social Developments in 1954", Ekonomi dan Keuangan Indonesia, VIII, (1955) Table II, 419.

These considerations are made rather academic, however, by the fact that Indonesia's major efforts in this field are currently being made to build up her foreign exchange reserves which have fallen to dangerously low levels in the years since 1952. By mid-1954, it became necessary for the government to suspend the 20 per cent gold and foreign exchange reserve requirement behind the current liabilities of the Central Bank, thus drawing attention to the necessity of further restricting imports to improve the foreign exchange position of the country. For some time to come, therefore, Indonesia's Balance of Payments problem is likely to be regarded as one concerned with accumulating foreign exchange for reserve purposes rather than to provide financial resources for development.

However, all of this overlooks one of the most essential characteristics of the Indonesian Balance of Payments: the extreme sensitivity of export earnings to fluctuations in world prices for primary products. As in other primary-producing economies, Indonesia's export earnings were swollen by the international stockpiling boom during the Korean War. However, as elsewhere, the resulting windfall profits--many in hard currencies--were dissipated in the financing of non-essential imports and internal inflation.[8] For long-term financing of economic development, therefore, it would be

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[8]See Douglas Copland, Problems of the Sterling Area, 1953, especially 20-28.

desirable to capture a share of these periodically large foreign exchange resources by appropriate fisacl and financial measures during periods of booms in the markets for primary products. These resources could be gradually invested in a development program to avoid the consequences of their expenditure during boom situations with inherent inflationary tendencies.

Sources of Finance: Mobilization of Voluntary Savings or Inflationary Government Borrowing

In the second place, we might consider the feasibility of financing Indonesian economic development through public or private mobilization of voluntary savings or alternatively, through creation of new money. In financing investment operations in the economy during the past five years, the banking system and the government have had little success in mobilizing voluntary savings from the economy. The growth of savings accounts and even of active private deposit accounts has been extremely small relative to the credit extended through the Indonesian credit complex. It is clear that the supply of money has grown as rapidly as savings accounts in the banking system and government agencies (such as the Post Office Savings Bank). Throughout the period since the transfer of sovereignity the ratio of savings deposits to total money supply has held fairly steadily near 3 per cent, compared to 19 per cent for India and about 45 per cent for the United States.[9]

[9] Douglas S. Paauw, "Financing Economic Development in Indonesia: Public and Private Mobilization of Voluntary Savings", Ekonomi dan Keuangan Indonesia, VIII, (1955), 209.

Rather than performing a function in mobilizing savings to finance the economy's investment, the banking system in Indonesia-with the exception of large foriegn banks-has been heavily subsidized by the government.[10] It appears highly doubtful, therefore, that the banking system will be available to mobilize savings to finance either private or public developmental expenditures in the near future.

During this same period (1950 to the present) the government has operated, with the exception of one year, at relatively large deficits, financed primarily by inflationary borrowing from the Central Bank. The Minister of Finance reported in June, 1955, that post-independence deficits totalled Rp. 9,966 million by the end of 1954, of which Rp. 6,5 million was financed by borrowing from the Bank Indonesia. He forecast a further deficit of Rp. 2,537 million for 1955.[11] Through stringent stabilization policies the inflationary effects of this borrowing was held in check until 1954.[12] However, by 1955 new and frightening inflationary tendencies were apparent, and it was clear that continued inflationary financing on the scale recently undertaken would seriously undermine the stability of the Indonesian economy.[13]

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[10] Ibid, 210, 213.

[11] Antara, (Indonesian Edition), June 14, 1955

[12] Benjamin Higgins, Economic Stabilization and Development in Indonesia, (Revised mimeographed edition, 1955), 20-21.

Limited evidence points to the conclusion that the pre-1954 stabilization policies of the Indonesian Government were effective in "neutralizing" at least part of the new money put into circulation through deficit financing. It appears that the velocity of money in circulation was reduced and that cash and near-cash balances grew rapidly in this period,[14] held against the day when they could be converted into the desired (primarily imported) goods. However, with the appearance of active inflationary tendencies in 1955, it appears that these balances are putting increased pressure on the free market rate of the rupiah and domestic commodity prices as attempts are made to convert cash balances into goods or foreign currencies as domestic price rises are becoming more ominous.

It should be pointed out, incidentally, that the existence of these balances in the face of inflationary pressures does not augur well for the mobilization of private savings as a deflationary means of financing economic development. To the extent that these balances would be mopped up for transfer to the government for development financing, their impact would be as inflationary as the creation of new money. Moreover, it is doubtful whether the owners of these balances

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[13] Ibid, 21-22

[14] Scheffer, C.F., "A Note on One Monetary Analysis by the Governor of the Bank Indonesia...", Ekonomi dan Keuangan Indonesia, VII, (1954), 652-657; National PlanningBureau, "Indonesia's Economic and Social Developments in 1954", Ekonomi dan Keuangan Indonesia, VIII, (1955), 360-361.

would be willing to part with liquidity by purchasing government securities or gaining title to savings accounts. If they are held for the motives suggested above, and are already being converted to goods as a result of inflationary price rises, their owners undoubtedly wish to maintain the highest degree of liquidity by continuing to hold cash.

Sources of Finance: the Fiscal System

If these observations are correct, the use of inflationary financing to support either current or developmental expenditures will have a multiplier effect on prices as inflation induced by the government deficit shakes loose the cash balances withheld from previous income streams. The launching of a development program in the conditions of this monetary overhang implies that inflationary financing must be restricted if economic stability is to be maintained. Hence it is my contention that during the first years of development, financing should come mainly from reductions in current consumption forced through fiscal measures. It should be recognized, however, that even this type of provision for the financing of developmental investment may have inflationary aspects. This is true since the monetary stream itself will not be contracting, while the flow of goods for consumption purposes will be reduced as a greater share of current resources are devoted to production of investment goods. On the other hand, the output increases that will eventually emerge from developmental

investment will not appear immediately. The gestation period before investment fructifies in output will vary from project to project, but in any case there will be considerable delay in output responses to investment. An inflationary gap will exist until the supply of consumption goods reaches (and exceeds) its original level. The inflationary consequences could be reduced by successively taxing away this gap in each economic period. It is also possible that the gap might disappear through enforced reduction in the propensity to consume among the higher income groups if luxuries and semi-luxuries upon which these groups were accustomed to spend a part of their incomes were made totally unavailable. As output increases result from the development program, the decision concerning allocation of these increments between resources for an increased rate of investment and provision for increased consumption will have to be made.

From our review of the feasibility of financing development from foreign trading operations, by mobilization of voluntary savings or through government deficit financing by creation of new money, it appears that financing a significantly increased rate of investment without deleterious inflationary consequences will require major reliance on the central and local fiscal processes. The level of net investment now being performed by the economy through both public and private channels provides a useful point for a development program thus financed. The existence of these investment resources *per se*,

however, does not imply that their present employment will lead to realization of the economic objectives for which capital requirements have been estimated above. Hence, some redirection of investment now carried out by public bodies may be required to eventually meet the objectives of raising per capita consumption.

Before turning to the search for new investment resources available through fiscal devices, the present level of net investment accomplished by the economy as a whole requires attention. In this connection, the Neumark estimate of investment performed by the Indonesian economy in 1952 should be regarded as unrealistically low. Although Neumark reported gross investment approximating 4 1/2 billion rupiah in this particular year, his estimate for net investment works out to only 600 million rupiah.[15] This is well below the level which appears to emerge from a more detailed Indonesian study based on the year 1953.[16] This study placed gross investment at approximately Rp. 9 billion, of which Rp. 1.6 billion represented capital formation by the central government. Employing the most realistic depreciation rates now available for the economy as a whole and correcting for somewhat lower depreciation

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[15] Neumark, D.S., "The National Income of Indonesia", <u>Ekonomi dan Keuangan Indonesia</u>, VII, (1954), 357-358. The estimate of net investment has been obtained by subtracting Neumark's estimate of depreciation in the economy (Rp. 4,296.8 million) from his estimate of gross investment.

[16] This estimate was near completion in 1954 and was shown to the present writer. It has not yet been released for publication. In contrast to the Neumark estimate, the study referred to here is based on extensive reports on private investment as well as analysis of government accounts.

of governmental facilities,[17] this study would point to a level of net investment in 1953 approximating Rp. 4.7 billion. However, even this estimate does not take account of the substantial amounts of investment carried out at the local levels of government and not subsidized by the central government.[18] Such investment, not reported in government accounts, was estimated to be somewhat in excess of Rp. 1 billion in 1953.[19] With this addition we arrive at an estimate of net investment for 1953 amounting to Rp. 5.7 billion.[20] This estimate may be considered as a provisional measure of the economy's investment performance in a representative year. From our point of view, this lump of investment is regarded as a credit against the capital requirements specified above, to which new investible resources may be added.

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[17] Neumark employed a depreciation rate of 5 per cent for the economy as a whole and points out that this rate compares favorably with those current in neighboring Southeast Asian countries. Neumark, op. cit., 357.

[18] The 1953 estimate of gross investment included only local investment directly subsidized by the Ministry of Interior, and documented in central government expenditure reports.

[19] Douglas S. Paauw, "The Role of Local Finance in Indonesian Economic Development", Ekonomi dan Keuangan Indonesia, VIII, (1955), 12

[20] As argued above, this indicates a higher level of investment than that usually reported for Indonesia. Assuming Indonesian Gross National Product was 10 per cent greater in 1953 than Neumark reported for 1952, gross investment would approximate 11 per cent of G.N.P. The latest estimate reported alsewhere places this ratio at 5 per cent. Office of Intelligence Research, Department of State, Report No. 6672 (August 25, 1954), 3.

It is difficult to document from empirical studies the existence of areas of taxable capacity which could be reached to mobilize resources for development through the fiscal system without socially harmful effects on levels of consumption. Yet certain general conclusions appear to be warranted from analysis of recent data and the beginnings of empirical research. In the first place, it seems safe to conclude that income has risen in the rural sector of the economy relative to the non-rural sector.[21] Secondly, recent studies indicate that in some areas, at least, a new class of relatively high income recipients has emerged in the rural sector[22] and that similarly, in some localities general per capita income increases have been realized.[23] Thirdly, it is clear that the tax burden upon the rural sector has fallen relative to incomes in this sector and that the rising incomes among particular groups and localities are, by and large, escaping tax levies on marginal income increases.[24] Finally, there is evidence

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[21] Neumark, _op. cit._, 351, for example, reports that "farmers... were absolutely and relatively better off in 1951 and 1952 than in 1938." Also see Douglas S. Paauw, "The Tax Burden..." _loc. cit._, 568.

[22] This conclusion, reported in my article, "The Tax Burden...", _loc. cit._, 571 emerges from unpublished studies undertaken by the Institute of Social and Economic Research at the University of Indonesia.

[23] Douglas S. Paauw, "The Role of Local Finance in Indonesian Economic Development", _Ekonomi dan Keuangan Indonesia_, VIII, (1955), 13.

[24] J.A. van Veen, "Some Notes on 'The Tax Burden and Economic Development in Indonesia'," _Ekonomi dan Keuangan Indonesia_, VII, (1954), 766-767; and Douglas S. Paauw, "The Role of Local Finance...", _loc. cit._, 8, 13-14.

which suggests that significant amounts of underemployed factors of production exist in the rural sector of the economy and that these too may be mobilized for investment purposes through fiscal operations of the lower levels of government.[25] This method of investment financing is already effectively employed in some areas of Indonesia.

In the non-rural sector of the economy, relatively high tax rates are assessed against personal and business incomes;[26] where these rates are effectively enforced they probably now stand near the point of seriously affecting production incentives. However, even in this sector, strict enforcement of the legal rates of these taxes against liable income is found only in the larger cities where central fiscal offices are actually located. In outlying cities and towns, an attempt is made to enforce these taxes by periodic visits from representatives of these offices. In addition, however, the central fiscal offices in the various provinces, provided with small enforcement staffs, are responsible for collecting a large number of low-yielding taxes, many of which involve complex enforcement procedures. With relief from responsibility for collecting these relatively unremunerative levies.

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[25] Douglas S. Paauw, "The Role of Local Finance", Loc. Cit., 9-11.

[26] The effective income tax rates in force today begin at 3 per cent and rise to 55 per cent, with a marginal rate of 75 per cent applicable on each 100 rupiah of income above Rp. 300,000. The corporation tax rates vary from 40 to 52 1/2 per cent of net profits with lower rates (25 to 40 per cent) in force for new firms during the first five years of their existence.

the addition of collection personnel and improved communications, fiscal officials in the areas studied indicated that yields from the two major revenue producers under their jurisdiction in areas outside Djakarta could at least be doubled.[27] Allowing for the loss of revenue from abolishing such high-cost collection taxes as the reconstruction tax (a tax on restaurants), the urban real estate tax and the household property tax, it is estimated that strict enforcement of the income tax and corporation tax in the non-rural sector could increase revenues by 1/2 to 1 billion rupiah.[28]

Direct taxation of the rural sector of the economy-which is the prerogative of the central government-is currently undertaken through a complex division of labor between the central government's fiscal offices in localities and local officials. Under the Dutch, rural incomes were taxed by means of a land tax, abolished by the Indonesians in 1951. In its place, so-called "rural income tax" (padjak peralihan ketjil) was established to tax income in the rural sector, applicable not only to income from land but to all income outside the reach of tax authorities in larger cities and towns. The land tax had been administered by the Dutch, typically, through their system of indirect rule. Local officials, supervised by central

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[27] Douglas S. Paauw, "The Role of Local Finance...", Loc. cit., 8.

[28] This estimate is based on tax collections for the year 1953 and is calculated from data on yields from income taxation by sectors made available to the author by the Ministry of Finance.

authorities, performed the actual collection of the tax, retaining a specified percentage of their collections as personal income. When the rural income tax was put into effect by the Indonesians in 1951, the central government did not have adequate administrative personnel to enforce the tax directly. As a result, this tax, too, has been farmed out to local officials for collection, with some important variations between Java and the Outer Islands. On Java, the rural income tax resembles the colonial land tax in almost every detail. Local officials are responsible for its collection up to specified amounts,[29] and it continues to be a tax on land collected at nominal rates in force before World War II. The local collecting official is still allowed to retain a personal share of revenues collected. On the Outer Islands, the tax is collected exclusively by local officials, theoretically supervised by the central fiscal offices in the locality. In practise central officials rarely penetrate into the villages. In these areas, where the colonial land tax never had a firm foothold, the rural income tax, to the extent it is enforced, is assessed at the progressive rates which the 1951 statute provides.

In 1953, total income tax collections received by the central government from the rural sector amounted to only Rp. 66 million;

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[29] Rupiah 3,400 in East Java; Rupiah 5,000 in West Java.

with proceeds of Rp. 30 million from Java and Rp. 36 million from the Outer Islands. Yet the rural sector produced in 1952 Rp. 65.2 billion of Indonesia's national income of 81.6 billion(81 per cent of the total).[30] The rural income tax contributed less than 1 per cent of total tax collections in 1953, compared with land tax collections comprising 7 per cent of the total in 1939.

In terms of aggregative statistics, therefore, it appears that direct taxation of the rural sector of the economy is ineffective in mobilizing resources for the finance of government expenditures, current or developmental. This conclusion is borne out by empirical research in localities on Java and the outlying islands. Upper incomes in the rural sector received by traders, lenders and landlords are by and large not reached by income taxation; on Java local collectors attempt to keep income assessments low enough to be liable to local collection so they may share in the proceeds. On Sumatra, tax collectors-who are in fact local officials-make no effort to maximize income tax collections in the rural sector since all receipts are turned over to the central government. In one area, on Sumatra, a drive by central tax officials to enforce taxation of upper incomes in the rural sector, tripled central receipts.[31]

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30 Douglas S. Paauw, "The Tax Burden...", Loc.cit., 568.

31 Douglas S. Paauw, "The Role of Local Finance...", Loc. cit., 8.

In the areas of Indonesia which I investigated, local fiscal officials at the provincial, kabupaten, and village levels indicated that the transfer of the rural income tax to these levels of government would in all probability make them financially independent of the central government and would also permit a higher rate of local investment.[32] In 1953, central subsidies to local governments amounted to Rp. 1.9 billion. If the rural income tax were transfered to local levels of government, where it could be more effectively collected, central government subsidies for the finance of local government could be considerably reduced if not eliminated. A conservative estimate of the savings realised by the central government budget through this transfer and the consequent reduction of subsidy might place the absolute figure between Rp. 1 to 1.5 billion. It is clear that the central government itself will not have the administrative facilities to mobilize collections in this amount from the rural income tax for an indefinetly long time.

Financial resources for development might well be provided by paring down the level of non-subsidy current expenditures supported by the central budget. Recent students of the Indonesian budget have suggested that strenuous economy efforts by the various Ministries represented in the budget could result in reducing current expenditures by at least Rp. 1 billion, while the existing level of administration could be maintained.

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[32] These levels of government now have no important, legally provided sources of income.

A more controversial item in the search for new investment resources for development is the amount of new local investment which might be encouraged by fiscal and administrative reform which would grant increased autonomy to local levels of government. The investment operationsof provincial and kabupaten levels of government now require central government approval of investment plans, and central financing. Yet apart from capital items and technical personnel, these projects could be financed locally, in large part from underemployed labor resources. In the areas of Indonesia which I visited, I found a dramatic urge for local improvement through local investment projects. In these areas, provincial and kabupaten fiscal offícals strongly indicated that if they were given carte blanche on planning and financing of investment projects within their jurisdiction, the amount of local investment realized could be significantly increased. While it is extremely hazardous to place a statistical value on the amount of new investment resources which could be mobilized through the extension of greater autonomy to localities (including transfer of the rural income tax) an estimate of a 50 to 100 per cent increase in local capital formation above that estimated for the year 1953 appears to be conservative.[34] This would provide additional investment

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[34] On Java and Sumatra local officials consistently estimated that this change would double the current rate of local investment. We have estimated total local investment for 1953 at Rp. 1 1/4 billion.

resources at local levels of government from Rp. .5 to 1 billion.

We are now in a position to put together our total estimate of investment resources available to the economy plus those which may be mobilized through the fiscal changes suggested here. This estimate may then be compared with our estimates of capital required to produce specified rates of economic growth. The results of our analysis are presented in Table I.

TABLE I

Total Investment Resources (Domestic)
(In billions of rupiah)

A. Estimated Actual Investment (1953):	
Gross	9.0
Depreciation	4.3
Net	4.7
Addition of unreported local investment	1.0
Corrected net total	5.7
B. Additional Potential Investible Resources:	
1. Increased yields from business and personal income taxation	.5 to 1
2. Increased yields from rural income taxation (Reduction of subsidies to localities)	1 to 1.5
3. Reduction in current central expenditures	1
4. Increased local investment	.5 to 1
Subtotal (B)	3 to 4.5
C. Total	8.7 to 10.2

This estimate of the economy's present investment resources is based on the estimated level of net investment now being performed by the economy plus fiscal resources which could be mobilized for development at existing tax rates and given a reduction in current expenditures of about 7 per cent below the 1953 level.[35] Item 1 in the above table, net increase in yields from business and personal income taxation (1/2 to 1 billion rupiah), requires stricter enforcement of existing tax rates in the urban sector and the abandonment of minor revenue producers which are costly in terms of administration. Item 2, increased yields from rural income taxation (1 to 1 1/2 billion rupiah), requires transfer of this tax to local governments. This transfer would add to central resources for investment by reducing subsidies to localities, now running at about Rp. 2 billion per year. Item 3, reduction in current central government expenditures (1 billion rupiah), requires more stringent budgetary control and somewhat simplified administration. Item 4, increased local investment (1/2 to 1 billion rupiah), requires granting greater autonomy to localities in investment activities, including the right to mobilize resources locally.

Apart from the reductions in the current expenditures of the central government, increased resources for developmental investment are

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[35] Excluding reduced subsidies to localities.

to be derived from taxable capacity theoretically subject to existing tax provisions but actually unreached by present tax enforcement. The estimates presented in Table I, therefore, are nothing more than an attempt to locate and quantify the potential yields from areas of taxable income presently outside the scope of enforcement. These estimates should be regarded as rough approximations made without the support of satisfactory statistical materials; the margin of error may be as high as 50 per cent in either direction. Nevertheless, there is evidence that tax yields can significantly be increased by stricter enforcement of existing tax legislation in the areas indicated and by the changes in inter-governmental fiscal relations suggested.

Of the total of new investible resources detailed in table I, Rp. 1 1/2 to 2 1/2 billion comprise effective reductions in the level of consumer expenditures or savings (increased central and local tax revenues); Rp. 1 billion represents the diversion of present government expenditures for resources for current purposes to investment; and Rp. 1/2 to 1 billion represents direct local mobilization of currently unemployed or underemployed resources. If the assumptions made are realistic, this means that goods available for consumption need be reduced by Rp. 1 1/2 to 2 1/2 billion to provide financing on the scale posited in table I. With enforcement of business and personal income taxation in the suggested areas of taxable capacity this increased tax take would presumably come largely from the category "other goods and

services"-non-food and non-essentials- available for consumption in 1956 whose value is estimated to reach Rp. 11.65 billion if Grasberg's minimum capital requirements are met.[36] Since tax rates applicable for business and personal income taxation are highly progressive, this additional levy would be presumed to leave consumption of food and other necessities (estimated to total Rp. 72.3 billion in 1956) relatively untouched.

The total of these resources obviously goes far toward meeting the estimated capital requirements, referred to above, necessary to raise per capita consumption by 2 per cent per year. At their minimum, present investment plus the addition investible resources in table I would provide financing for net investment totalling Rp. 8.5 billion in, for example, 1956 as against estimated capital requirements of Rp. 13 3/4 billion, leaving a gap of Rp. 5 1/4 billion (approximately 460 million U.S. dollars). At their maximum, total investible resources under the program suggested here would total Rp. 10.2 billion leaving a domestic financial gap of Rp. 3.55 billion (approximately 310 million U.S. dollars).

The estimates of the rate of domestic investment presented here suggests that the Indonesian economy today is capable of maintaining the 1954-1955 levels of per capita consumption, limited though they

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[36] Grasberg, op. cit., Table 5.

were by the government's retrenchment policies. Grasberg's estimate of net investment necessary to achieve this goal was placed at Rp. 5.3 billion; we have estimated that net investment totalling Rp. 5.7 billion was accomplished in 1953. However, the rate of investment now performed is scarely adequate to restore levels of consumption to position of 1952 before retrenchment was begun, and is inadequate to build up the country's foreign exchange reserves by gradual reduction of the import of items which can be produced in Indonesia. This underlines the necessity for mobilizing additional financial resources for an aggressive development program if at the minimum, short run economic stability is to be pursued.

The public component of developmental investment required to meet targeted growth rates might well be reduced by the expansion of domestic private investment. It is reasonable to expect that private investment would increase in the atmosphere of expansion created by a government sponsored development program. New profit opportunities should arise as external economies, industrial raw materials and an increasingly skilled labor force emerge. It would be hoped that the expansion of private investment could be financed by mobilization of voluntary savings from current income through private banking channels; in fact, government policy should be aimed at developing the Indonesian banking system to assume, at a minimum this role in the financing of Indonesian economic development.[37]

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[37] This point is expanded in my paper, "Financing Economic Development in Indonesia: Public and Private Mobilization of Voluntary Savings.", loc. cit.

The Importance of Foreign Capital

An inflow of foreign capital to complement the mobilization of domestic investible resources in financing Indonesian economic development is important, in fact critical, for a number of reasons. In the first place, the mobilization of domestic resources without inflationary consequences, under the conditions described in this paper, falls short of the estimated capital requirements needed to provide significant increases in per capita output. Moreover, at the present level of government expenditures (about Rp. 15 billion per year gross), the government has been operating at an annual budgetary deficit averaging about Rp. 3 billion. The deficit has been financed almost exclusively by inflationary methods (primarily borrowing from the central bank) resulting in severe pressures on domestic price levels. Unless external funds are made available, a development program of the size indicated by the estimate of Indonesia's capital requirements would require continnued inflationary financing by the government. In the nascent inflationary conditions now existing in Indonesia, continued inflationary stimuli would jeopardize both the economy's stability and development.[38] Experiments in inflationary

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[38] Indonesia's National Planning Bureau has recently emphasized the importance of reducing inflationary pressures if economic development is to be seriously undertaken. In their recent report the following statement is put forth, "The Five-years Development Plan, which is now a subject of study of the Planning Bureau, would not be workable if a persistent budgetary deficit disturbing the necessary economic balance, is not eliminated in a reasonable period of time." National Planning Bureau, "Indonesia's Economic and Social Development in 1954," *Loc. cit.*, 411.

financing in Indonesia in the past few years have demonstrated that increases in money supply have failed to produce complimentary increases in output. Although it is clear that underemployed factors of production exist in particular sectors of the economy, they have not, by and large, been brought into productive use by the increase in demand generated by deficit financing.

An inflow of foreign capital is also required to meet the foreign exchange requirements involved in launching a development program on the scale considered here. In an economy with an underdeveloped industrial structure, an important share of the physical capital goods, for development, and in the case of Indonesia, of the raw materials for industrial production, must in the short-run be obtained from abroad. We know little about the required foreign trade ingredient of capital formation in countries at the stage of Indonesia's development, but a preliminary estimate may be ventured on the basis of Indonesia's own experience and estimated requirements in other underdeveloped economies.

In 1953, the year employed as the basis of the present estimates, imports of physical capital goods totalled Rp. 1.44 billion (about 14 per cent of estimated gross investment) and imports of raw materials totalled about Rp. 2.6 billion (about 26 per cent of estimated gross investment). Combined, therefore, imported capital goods for domestic investment and raw materials-in large part fabrics for the textile

industry-for industrial production represented about 40 per cent of realized gross investment. Imports in these categories were given priority in import licensing and were achieved only at the expense of severe limitation of imported consumer goods. It is realistic to beleive that the ratio of the imported capital component to total investment would rise as a development program got underway. Investment realized in the Indonesian economy in 1953, apart from government capital formation, appears to have been accomplished predominantly in the agricultural sector, small-scale industry and construction. In these sectors, the performance of investment is less capital intensive than in the extension of the economy's social overhead investment and the development of an industrial base which are dominant in Indonesia's present five year plan.[39]

If the allocation of Indonesian investment in the next five years follows the contours of this five year plan, it is reasonable to suppose that the import component of gross investment would be slightly more than double the present rate (14 per cent). If the Planning Bureau estimate of 50 per cent in foreign exchange costs (for the five year plan)

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[39] The proposed allocation of investment resources in this plan among major sectors is as follows: Industry and mining, 25 per cent; public power and irrigation, 25 per cent; transport and communications, 25 per cent; education, health and other social, 13 per cent; agriculture and transmigration, 12 per cent. Dr. Djuanda, Director of the National Planning Bureau estimated that it would be necessary to devote 50 per cent of the investment resources to meet foreign exchange costs of these investment projects. Antara Daily Newsbulletin, Amsterdam edition, March 17, 1955, 1.

is employed for the additional gross investment called for by the Grasberg estimates to bring per capita consumption increases of 2 per cent (Rp. 8.2 billion), the average import component would work out to approximately 30 per cent.[40] If anything this estimate would be on the conservative side since the present pattern of investment might be partially shifted to sectors where investment would require a higher import component. To a limited extent, this would be offset by the fact that the pattern of financing outlined here would in part rely on the use of localized resources for labor-intensive investment.

It appears clear that foreign exchange requirements of this order of magnitude will remain beyond the foreign exchange earning capacity of the Indonesian economy over the life of a short-run development program (e.g. 5 years), thus underlining the need for foreign capital in financing the development program. Since 1952, the Indonesian government has strictly limited the use of foreign exchange for the import of consumer goods; import of capital equipment and raw materials have comprised an increasingly large share of the country's total imports.[41]

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[40] The present level of gross investment is estimated to be RP. 10 billion with an existing import component of 14 per cent. For additional investment (Rp. 8.2 billion) the five year plan estimate of a 50 per cent import component is employed. Thus:

$$\frac{14 \times 55 + 50 \times 45}{100} = 30.2$$

[41] 45.3 per cent in 1952, 53.8 per cent in 1953 and 57.9 per cent in 1954 (January to September), Bank Indonesia Bulletin, Third Quarter, 1954 (Djakarta, 1954), 19.

By 1954, it was apparent that the import of consumer goods could be reduced no further without reductions in the supply of basic necessities in the economy. In fact, in that year it was felt that, "there are limitations that can be achieved in the consumption sector (of the import accounts); after a certain point further reductions in supplies being increasingly difficult to bear. Therefore, to achieve the required decrease in foreign exchange expenditure some reductions in the productive sector (of the import account) were unavoidable."[42] Even so the import of consumer goods was reduced 33 1/3 per cent below the 1953 level.[43] On the other hand, as we have pointed out above, the ability of the economy to earn significantly greater amounts of foreign exchange in the short-run is extremely doubtful, barring fortuitous rises in world prices for Indonesia's major exports. What surpluses are earned must, for sometime to come, be used to build up Indonesia's foreign exchange reserves. Thus it seems safe to conclude that the import of capital goods for an expanded development program cannot be financed from increased export earnings or by providing foreign exchange from

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[42] National Planning Bureau, "Indonesia's Economic and Social Developments in 1954", Loc. cit., 369. Parenthesis are my addition.

[43] Ibid, 369.

further reductions in the level of consumer goods imports.

Employing the assumed ratio of foreign capital goods to gross investment (30 per cent), a development program aimed at providing annual per capita consumption increases of 2 per cent would involve Rp. 5.46 billion in direct import costs.[44] In 1953, the most recent year for which complete statistics are available, the economy was providing capital imports totalling Rp. 1.44 billion. Assuming this rate will be maintained in the short run, the development program outlined here would entail Rp. 4.02 billion (about U.S. $350 million) in foreign exchange costs for realizing investment. Like investment requirements themselves, these costs would increase each year as a larger base against which replacement for depreciation must be made is accumulated.

Financing Economic Development in Indonesia: Some Implications

We have sought to establish the thesis that a program of development leading to eventual increases in per capita consumption could be financed largely from domestic resources but that foreign capital must play an important, in fact critical, role if Indonesian economic growth is to be assured. We have argued that domestic resources should be mobilized through devices which will limit the short-run inflationary consequences of diverting current resources to production of capital

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[44] Grasberg's figure (op. cit. Table 6) for required gross investment in the first year of the new level of investment is Rp. 18.2 billion

goods. Rough estimates of the order of magnitude have been assigned to the capital needs of the economy and the investment resources which might be mobilized by the suggested devices to meet these needs. These estimates should be regarded as extremely tentative; detailed studies on both sides of the economic ledger are suggested before planning be undertaken on the basis of the limited and preliminary studies to which we now have access.

A major implication of the pattern of financing outlined here is that mobilization of investment resources and the administration of development investment itself would be carried out by local governments as well as by the central government. About 17 to 22 per cent of the new fiscal resources for development would come from local governments, according to my estimates; and, to this extent, the investment program would be prosecuted on a decentralized basis rather than through the central government. The question then occurs as to whether or not local administrative facilities are available to carry out investment at these levels of government. My own impression is that a reservoir of competent officials, not fully utilized under the present system of inter-governmental division of functions, exists at these levels. A more serious economic question is whether or not the resources made available at the local level could be integrated into a general development program aimed at increasing production. The problem is that resources mobilized by localities tend, by their nature, to be highly

localized. However, it is my opinion that Indonesia's development program will have to concentrate in part on providing basic local facilities such as irrigation works, transportation facilities and small-scale, state-operated productive enterprises. What evidence we have suggests that local investment resources can most easily be mobilized in the outlying islands where these facilities are most lacking. In my experience, local governments already assign high priority to productive projects and allocate resources on the basis of estimates of the productivity of alternate uses.[45] Thus it appears that diversion of local financial resources to projects related to the country's economic growth is not an insurmountable problem.

Moreover, the degree of decentralization implicit in the composition of fiscal and financial resources suggested by this study may well ease the process of transformation of financial resources into capital goods. Japan's experience suggests that capital formation in the sectors appropriate to local investment and the early stages of development can largely be realized from conversion of resources available to the underdeveloped economy.[46]

There are also important publicity aspects related to the program recommended here. The pattern of financing is obviously one of austerity since it implies generally reduced levels of consumption, particularly

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[45] In fact, in one area I found rather sophisticated use of capital-output ratios to establish investment criteria.

[46] Lockwood, The Economic Development of Japan (Princeton, 1955), Chapter 5, especially pp. 246 and 301.

among the upper income groups. Yet, it is emphasized that by tying local benefit to sacrifice it might become clear to the Indonesian people that eventual increases in consumption will result from the government program and that today's sacrifice would be tomorrow's gain. Thus the local aspect of financing the program may well be a blessing in disguise. Finally, this program may well tend to allay some of the existing political objections to foreign participation in the financing of Indonesian economic development. Recognition of the fact that domestic financing of investment entails sacrifice in the way of reduced consumption may well add to the attractiveness of foreign capital. Again, the fact that the program outlined here calls for substantial domestic financing implies that the domestically owned sector will be rapidly expanded relative to the foreign-owned sector even if foreign capital enters as direct investment. New productive facilities will be primarily Indonesian owned and the scope of foreign ownership will be circumscribed by the overall financing of the program itself. If it is clear that the indigenous role will be the dominant one in financing and prosecuting development, fear of foreign domination in the modern sector may be considerably reduced and foreign capital may be welcomed as a complement in the total program for Indonesia's economic progress.