SOME ASPECTS OF FINANCING ECONOMIC DEVELOPMENT IN UNDER-DEVELOPED COUNTRIES WITH SPECIAL REFERENCE TO INDONESIA

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Thesis presented to the Faculty of Social, Economic and Political Sciences of the University of Ottawa as partial fulfillment of the requirements for the degree of Master of Arts

Ottawa, Canada, 1963

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INTRODUCTION

In achieving a higher standard of living, economic development remains a matter of major concern for all countries of the world, but particularly so for the poor and underdeveloped countries. In fact, since the second world war, many of these countries, especially some newly independent nations, have become aware of the problem of poverty, and have taken steps to stimulate economic development both in the public and private sector as a key solution to their difficulties. The rate at which capital formation has been taking place in many countries in recent years, however, has not been high enough to permit a significant rise in the level of living; in some cases, it has not been even sufficient to keep pace with the increase in population.

Many factors, of course, have been and are hindering the growth of adequate investment, e.g. lack of a well-organized capital market, lack of an experienced entrepreneurial class, lack of efficient administrative machinery, doubt as to the opportunity of profitable investment, and the fear of political and economic instability. But a fundamental, though not the only limitation to growth is the low level of available and potential domestic savings. Although during the last decade, a considerable amount of foreign assistance and capital has been extended from some advanced countries and international agencies, the financing problem is mainly one of internal finance. The requirements of funds and resources from the domestic economy are still extremely large. Each country must look to its own resources and rely on its own effort for much of its own development. Yet, any attempt to apply the short-cut method of "printing money" may be disastrous and the exclusion of foreign sources unrealistic. It is the purpose of this thesis to inquire into this financing problem of economic development in underdeveloped countries, with special reference to Indonesia, the country which shares many common features of underdeveloped economy and has, at the same time, some characteristics of its own.

Indonesia is a tropical South-East Asia country, blessed with fertile soil and a variety of natural resources, but undergoing a rapid growth of population, and inheriting a colonial economy which earns its living mainly through the export of some primary products. The country's financial aspect has been critically complex and extremely difficult since the sovereignty. The failure to finance a substantial amount of investment for achieving a higher rate of growth has to be considered on the basis of economic background as well as in the context of social and political elements.

An "underdeveloped country" in the economic sense is one in which "on the whole, production is carried on with a relatively small amount of real capital per head and with relatively backward techniques in the broadest sense of the word".[1] Thus the usage of the term "underdeveloped countries" in this study refers to many countries in Asia, Africa, South-Eastern Europe and Latin America, which have more or less a common underdeveloped condition. But examples and figures are sometimes given with respect to Asian countries, because they constitute a major part of underdeveloped areas and also, materials on these areas are more readily available to the writer. Economic development may be defined as "the process of increasing real capital and improving techniques of production".[2] Financing economic development involves means that a government and a people take to bring together financial and human resources, either domestic or foreign, for investment purposes.

Chapter I of this thesis will give a general survey of Indonesia's economic background. In the latter three chapters, in which every financing aspect of underdeveloped countries is studied, special reference will be made to the Indonesian problem. Thus, conclusions will be drawn

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[1] United Nations, Methods of Financing Economic Development in Underdeveloped Countries, Nov. 1949, p. 90.

[2] U.N., Op. Cit., p. 90.

generally about underdeveloped countries as well as specifically about Indonesia. Two important aspects of domestic financing: private voluntary savings and government financing will be studied in Chapter II and Chapter III respectively. In the former chapter, the role of financial institutions in relation to voluntary savings and economic development, as well as measures to increase private voluntary savings will be discussed; the latter chapter will be devoted to the problem of deficit financing, inflation, and the role of taxation. Foreign sources of financing will be reviewed in Chapter IV with attention to the need of foreign capital, domestic absorptive capacity, and foreign assistance and investment.

CHAPTER I

GENERAL ECONOMIC BACKGROUND OF INDONESIA

1. Geography, Resources and Population

The Republic of Indonesia consists of six main islands namely Java, Sumatra, Kalimantan (Borneo), Sulawesi (Celebes), West Irian (Western New Guinea), and Bali, and also more than 3,000 smaller islands stretching in a long arc from a point opposite the Northern tip of Australia. The island chain, which extends some 3,000 miles from East to West, is surrounded by the South China Sea and the Indian and Pacific Oceans, and has a land area of about 576,000 square miles, making it the third largest country in area in the Far East.[1] But because of its separate area, transportation has always remained a serious problem.

Indonesia is a tropical country. However, despite the fact that no point of the country is more than 11° from the Equator, the heat is tempered by mountain elevations and ocean winds. The mean annual temperature at coastal sea level points is about 77° to 81° F., and rainfall is heavy in nearly all parts of Indonesia.[2]

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[1] U.S. Dept. of Commerce, "Basic Data on the Economy of Indonesia". World Trade Information Service, Part 1, No. 58-84, Nov. 1959, p. 1.

[2] Ibid., p. 3.

Indeed, the country's tropical sun and almost year-round rainfall, coupled with fertile soil constitutes one of Indonesia's most important natural resources. Highest fertility is found on Java, and permits two or three crops a year throughout much of the island. These soil and climate conditions enable the country to produce not only a considerable amount of foodstuffs (mainly rice, cassava and maize) for the prople, but also the great plantation in industries (mainly rubber, copra and tea).

Indonesia is often referred to as being rich in natural resources. But economist B. Higgins, who knows Indonesia well, indicated that "the quantity and quality of some of these resources is not impressive in relation to the size of the population; the quantity and quality of some others are not thoroughly known."[3]

What probably is true is that Indonesia has a wide variety of resources especially minerals, although the wealth is by no means as great as many people believe, and in fact many of these resources have never been carefully explored. The country's petroleum is the largest known source in the Far East. Tin and bauxite are the two other most important resources. There are also deposits of gold, silver, iron, coal manganese, nickel, diamond, copper,

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[3] B. Higgins, Economic Development, N.Y., W. W. Norton & Company Inc., 1959, p. 51.

sulfate, lead and zinc. Hydro electric potential also exists in some areas.[4] On the whole, Indonesia is relatively well-off in natural resources among its neighbouring countries.

Indonesia's estimated population at the end of 1961 was close to 96 million[5], placing it sixth among countries of the world in population. Population distribution is very uneven, to the extent that three-fifths of the population are crowded into the one small island of Java, and the rest of the population scattered among other islands, some of which are several times the size of Java. Consequently, Java with nearly eleven hundred people per square mile, becomes one of the world's most densely populated areas. The pressure of population on resources in the island seems likely to be an increasingly serious and difficult problem.

Indonesia's population is predominantly of Malay origin and Moslem religion. Ethnic and cultural differentiations are extensively varied with geographic location. Some language and dialect differences are also distinct. Other important racial elements are the Chinese, Arabs, Indians and Europeans. The Chinese, who are the most numerous of the non-Malay, are mostly engaged in trade and in

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[4] Ibid., p. 51.

[5] United Nations, Economic Survey of Asia and the Far East, 1961, Bangkok, 1962, p. 168.

other diverse fields, while the Europeans mainly are related with industries and banking. Their important economic position, however, has greatly declined since independence.

2. General Structure of the Economy

Considering both its contribution to national income and employment, agriculture is by far the most important sector of the Indonesian economy. Agricultural activities as a whole, including forestry and fishing, accounted for well over half the national income in 1959[6], and about two-thirds of total employment[7]. Agricultural exports also comprised about 68 per cent of total exports in 1959.[8]

Small-holder productions center around rice, corn, cassava (tapioca), sweet potatoes, sago, peanuts, soybeans, etc., and are carried on mostly by Indonesians. Estate agriculture is characterized by large scale operations under foreign capital and management, and is generally identified with the cultivation of a single crop.[9] The most important

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[6] United Nations, Op. Cit., p. 170.

[7] National Planning Council, Report on the Execution of the Five-Year Development Plan 1956-1960, Djakarta, Sept. 1962, p. 57. (Mimeographed)

[8] Bank Indonesia, Report of Bank Indonesia, 1959-1960, p. 121. The Bank has issued no annual report since 1960.

[9] United Nations, Op. Cit., p. 110.

crops grown on estates include rubber, tobacco, sugar, palm oil, hard fiber, coffee, tea, cacao and cinchona. About two-thirds of the agricultural population live on Java, mainly engaged in rice production and some estate plantation. Sumatra, with its much smaller share of the population, has most of the great plantations.

Rice is the economic foundation of native agriculture and the major staple food of the Indonesian diet. Ever since independence, the country's basic concern has been to secure adequate food especially for its increasing population. Acreage under rice cultivation has been increasing in recent years, the degree of increase has not been sufficient to keep pace with the rapidly increasing population and consumption demands. Because of this inadequate local output, imports of rice rose persistently from 9 per cent of total imports in 1951 to 22 per cent in 1960. The goal of the country's three year food production program intended for self-sufficiency in rice by the end of 1962 could no longer be achieved. On March and April of 1962, the government declared that Indonesia was the biggest rice importing country in the world, and that the government intended to import no less than 1.1 million tons of rice during the year.[10]

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[10] J. M. Van Der Kroef, "Indonesia Economic Difficulties", International Journal, Vol. XVII, No. 4, 1962, p.400.

Rubber is Indonesia's most important export crop and the leading foreign exchange earner. In 1959, rubber alone, accounted for 52.7 per cent of the total exports.[11] Because of the lagging of rubber replanting, output has recently been falling, and Indonesia appears to be gradually losing ground to the Federation of Malaya as the world's largest producer of natural rubber.

Until the beginning of the 20th century, Indonesia was almost exclusively an agrarian country and the few established industries, such as sugar mills, tapioca flour mills, indigo mills, were complementary to the major business of agriculture. The new Republic of Indonesia inherited a country largely agrarian, with very little heavy industry, but with a considerable variety of small and medium-scale enterprises turning out manufactured goods.

Industry, including the small-scale and cottage industries, accounting for only 8 per cent of the national income in 1959 (see Table I below), is nevertheless considered as making an important contribution to the overall economy. Moreover, as in other underdeveloped areas, it is a segment of the economy for which expansion is greatly desired and it plays a prominent role in all recent development plans.

Indonesian industries roughly fall into two types:

[11] Bank Indonesia, *Op. Cit.*, p. 121.

TABLE I

National Income of Indonesia by Industrial Origin
1951, 1952 and 1959

(In percentage of Domestic Product)

	1951[1]	1952[1]	1959[2]
Agriculture (including forestry and fishing)	55.7	56.5	56.0
Industry	8.7	8.2	8.0
Mining	2.2	2.3	2.5
Transport and Communications	2.8	3.0	33.5
Trade, Banking and Insurance	15.2	13.4	
Government	5.6	6.4	
Other	9.8	10.2	
Total -	100	100	100

Sources: 1) Daniel S. Neumark, "The National Income of Indonesia 1951-1952", Ekonomi dan Keuangan Indonesia, June 1954, p. 354-355.

2) United Nations, Economic Survey of Asia and the Far East 1961, Bangkok, 1962, Table 6, p. 171.

Processing of primary products for export or domestic consumption, and production of consumer goods dependent on both domestic and imported raw materials. In the first category are the refining of petroleum, smelting of tin ore, and the processing to some degree of various estate products, such as rubber, tea, sugar, coconuts, palm seeds, sisal and kapok, etc. The manufacturing of other consumer goods tends to rely more heavily on imports of raw materials or components. For example, nearly all raw materials for textile and paper industries have to be imported; and many assembling plants for radios, bicycles, cars and other products have a high proportion of foreign components.[12] These, as well as other locally made commodities, such as tires, rubber shoes, batteries, soap, margarine, cigarettes and light bulbs, meet a large part of domestic demand. From an overall viewpoint, however, Indonesia is self-sufficient in relatively few items and imports most of its requirements of consumer goods as well as capital equipment.

Most of the large industries are in the Outer Islands especially in Sumatra, Kalimantan, and Sulawesi, and were established before World War II by foreign investors, such as the big three oil industries: Standard-Vacuum Petroleum, Caltex Pacific Petroleum, and Royal Dutch Shell. The Indonesian government has greatly participated in plans to

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[12] United Nations, Op. Cit., p. 112.

expand industry in recent years, and some results have been obtained even though they are still far below expectations. Indonesian private participation is largely confined to small plants and handicrafts in Java.

The Indonesian industrial sector has faced numerous hardships and uncertainties ever since independence. Instability and inflation have made profit possibilities in the short run less attractive than investment of similar amount in commercial speculation. Difficulties also arise from the inadequacy of local capital, lack of experienced technicians, foremen, and managerial personnel. Recent industrial production continues to be plagued by inadequate imports of raw materials and spare parts due to import regulations, and also hampered by power shortages and transportation problems. Few industrial plants have managed to operate close to rated capacity during the last few years.[13]

Indonesia is primarily an exporter of agricultural and mineral products and an importer of consumer and capital goods. It has long had, almost consistently, an export surplus. An exception was in the damage and dislocation of the war and the postwar revolution and, again in 1952, when exports dropped sharply after the Korean boom peak in 1951

[13] U.S. Dept. of Commerce, "Economic Developments in Indonesia 1960", World Trade Information Service, Part 1, No. 61-55, June 1961, p. 8.

while imports continued to climb on the basis of income carried over from the boom.[14]

From independence to 1959, exports have varied in value from about Rp. 8.6 billion to 11 billion per year, except in 1951 when the Korean boom brought the value of exports up to Rp. 14.3 billion.[15] Because of the downward trend in the production of agriculture exports in recent years, export earnings have been affected, and so has the import capacity. The share of agriculture products in total exports declined from 77 per cent in 1951 to 68 per cent in 1959.[16] If it had not been for a continuous increase in export of petroleum and its products, exports would have declined much further.

Traditionally, rubber and petroleum are the two prominent export items. Other exports include only tin and tin ore, and a number of other agricultural products such as tea and copra. Thus, Indonesia's export base is one of the narrowest in the world, and creates its own problems. Like other underdeveloped countries dependent on raw material exports, the Indonesian economy is greatly affected by

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[14] The Java Bank, Report for the Java Bank, 1952-1953, p. 112.

[15] Bank Indonesia, Report of Bank Indonesia, 1952-1953 through 1959-1960.

[16] United Nations, Op. Cit., p. 111.

external demand and supply conditions, and becomes highly unstable. An unfavorable balance of payments tends to appear whenever prices of its principal exports drop.

Indonesia imports consisted primarily of a variety of consumer goods, and raw material and auxiliary goods to support the domestic consumer goods industries. From 1957 to 1959, the trend was toward reduced imports of consumer goods and increased raw materials and auxiliary goods, with the value of imported capital goods remaining steady. But since 1960, the trend seems to change again to the increase of consumer goods and capital goods, with rice, textiles, and machinery and transport equipment as the major individual items. In 1960, consumer goods accounted for 44.9 per cent of total value of imports, raw materials and auxiliary goods accounted for 28.1 per cent, and capital goods 27 per cent.[17] About half of this unusual increase of consumer goods was attributed to the import of rice to meet the severe food crises.

Most exports have regularly gone to Western European and Asian countries, which together took about 78.8 per cent of the total in 1959.[18] Most of the remaining exports go to the United States. Of the exports destined for Asian

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[17] United Nations, Op. Cit., p. 190.

[18] Report of Bank Indonesia, 1959-1960, p. 118.

areas, however, between one half and two-thirds are shipped to the entrepot port of Singapore from which shipments are transhipped to many countries. Asian countries as a geographic unit have been the main suppliers too. Imports of manufactured goods from Japan and Hong Kong, rice from Burma and Thailand, and other consumer goods and materials from the Chinese People's Republic have been large.[19]

In considering the general structure of the Indonesian economy, we may summarize by saying that the country's economy is mainly agricultural. Industrial development is small in relation to the size of the population and national income. The patterns of Indonesia's international trade reflect both the essentiality of and the excessive dependence upon the export of primary products. Commercial activities are another important source of income and employment of the economy. They have long been dominated by Western commercial and banking firms and by the Chinese, but are now increasingly controlled by Indonesians, mainly as a result of the introduction of the "Benteng Program".[20]

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19 Report of Bank Indonesia, 1959-1960, p. 118.

20 "Benteng Program" refers to the government's economic policy immediately after independence, seeking the growth of an Indonesian business class to replace existing Dutch and Chinese firms. It sought to foster Indonesian enterprise by largess of capital, credit, and positions of special privilege. This movement, actually, has not developed the economy very much because of the inadequacy of effective Indonesian entrepreneurship.

3. Political Background

In December 1949, Indonesia, which was a former Dutch colonial area, became a sovereign independent state, and from August 1950 has been the Republic of Indonesia, a constitutional democracy with a unitary form of government.[21]

Between the declaration of independence in 1945 by Sukarno[22] and the transfer of sovereignty in December 1949, there were nine governments. Since then there have been nine more.[23] It is this sequence of eighteen governments in seventeen years that has given us the strong impression of political instability. Though there has been more continuity of government policies than of government, the struggle for power among political leaders and parties, and the conflict between central government and the Outer Islands (as represented by the military commanders of the regions) have undoubtedly affected the country's vital task of economic development.

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21 Prior to August 1950, there was loose federation of States, the Republic of the United States of Indonesia. Fearing that the Dutch might continue to divide and rule, the Indonesian leaders worked for a unitary state which was instituted as the Republic of Indonesia.

22 Sukarno is a nationalist of Indonesia, great leader of the revolution, and the first and the present President of Indonesia.

23 B. Higgins, Indonesia's Economic Stabilization and Development, New York, Institute of Pacific Relations, 1957, p. 107.

Indonesia has a multiple-party system, with several major parties and a score of small ones. The most important parties in terms of popular support are: The P.N.I. (Nationalist Party), Masjumi (Moslem Party), Najdlatul Ulama (Moslem Scholar Association), and the P.K.I. (Communist Party).

It is very difficult to rank Indonesian political parties from "left" to "right", because their policies usually run across party lines, and each major party is split within itself on basic issues. If "right" stands for nationalist tendency, all parties are more or less of the right. If "left" symbolizes socialist, collectivist, or anti-capitalist ideas, they are all of the left wing. Most obviously split within the party is the P.N.I., with its extremist and moderate factions; the former leaning far toward the Communist Party (P.K.I.) in their sympathies, and favouring the abolishment of the remnants of foreign influence, the latter being essentially anti-Communist, more economics-minded and pro-Western. However, in the whole country's relations with foreign nations, all the four major parties follow the neutralist path.

Despite their difference in emphasis, all parties in Indonesia are agreed on transferring the colonial economy into a national economy. But to most of them, a national economy means Indonesianized rather than nationalized, that is, to become "national" by driving the foreigners out and by the seizing of properties, rather than, like India and Philippines, by following policies which would assure an increasing domestic share in new investment. All parties also have in mind the national goal of organizing the economy along cooperative lines as was written in their Provisional Constitution. But again, this goal lacks clear definition, and the interpretation usually differs from one leader to another.[24]

Thus, there was, from the beginning, agreement that Indonesia was not to be developed on capitalist lines. All parties are regarded as anti-capitalist, by which it really meant being anti-colonial and anti-imperialist, rather than strict opposition to private enterprise.

Similarly, while every Indonesian knew that the political system was to be democratic, many of them maintained that it should not be in the ordinary Western sense. It was to be an Indonesian democracy, reflecting the spirit of "gotong-rojong" and "musjawarat desa" traditions (community mutual aid and government by consensus rather than majority).[25] In Indonesia, the traditional way of getting things done is that every action taken should represent unanimous opinion

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24 B. Higgins, Economic Development, p. 736-737.

25 Ibid., p. 736.

rather than the will of the majority. The Western concept of individualism, and the Western view of "fifty per cent plus one per cent is right" should be rejected by all Indonesians, even by the Parliament, as was advocated by their great national leader President Sukarno in March 1956.[26]

Much time and energy of the people and political leaders was dissipated in fruitless discussions at the ideological level, which usually produced few concrete economic and social policies. Many questions concerning economic development can never be answered in terms of economic effectiveness alone. At some point, they always run into an ideological or nationalist issue. All these were important factors that have prevented the adoption of effective measures to unify the country and raise its standard of living.

This failure in economic progress has, in turn, aggravated the growing discontent in the Outer Islands where the big plantations, mines, and oil fields are located, and culminated in the declaration of a Revolutionary Government in February 1958, with its headquarters in South Sumatra. It is too simple to describe this rebellion as an anti-Communist revolt. It should be regarded as an action taken against left-wing tendencies, corruption, and unsatisfactory economic policies of the Central Government. It is also the

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26 B. Higgins, Indonesia's Economic Stabilization and Development, p. 100.

reflection of the Outer Islands' desire to increase regional and local autonomy. Although this rebellion had unfavourable effect on the Indonesian economy in 1958, it has also forced the government to take up more effective policies on economic stabilization and development.

4. Economic Development Plans

The need for economic development and the government's role as leader in planning and carrying out such development have been recognized by some outstanding Indonesians for years - even before the attainment of sovereignty. Independence was looked upon as the opportunity to develop the economy in raising the living standards of the people. Yet, serious obstacles have been encountered in undertaking developmental efforts and even in preparing plans for economic growth.

Throughout the postwar period, political problems have absorbed the energy of most governmental officials and political leaders, and thus have diverted efforts from tasks more directly related to economic development. The severe economic setbacks resulting from the war and revolutionary period necessitated the government's great attention to rehabilitation, establishment of law and order, organization of basic government services, and short run political and economic stabilization before placing emphasis on further growth.

Although agreeing on the need for development and increasing economic welfare for the people, Indonesian leaders were divided in their opinion regarding the means of achieving it. While some believed that Indonesia could develop only through outside assistance, many believed that the country could develop - even though slowly - by relying on the domestic resources. Since capitalism was usually equated with foreign exploitation, imperialism and colonialism by most Indonesians, there often existed some emotional obstacles to a rational policy toward foreign investment as part of an economic development program. Many of the political parties seemed to promise social justice and welfare and a better distribution of current production rather than more urgent economic construction.

Indonesians fought for independence, because they wanted a higher standard of living. But sovereignty and prosperity were so directly linked in their minds that they thought prosperity would automatically come to them once they obtained "Merkeda" (independence or freedom), and that every one of them would live like a "tuan-tuan besar" (boss). When their dreams of immediate prosperity out of sovereignty were not realized, there was a tendency to complain that that was because the foreigners were still present, and that their revolution was incomplete. They thought that only by driving all the Dutch and the Chinese out would they enjoy the prosperity expected from revolution.[27]

In other words, the people were looking too much to a redistribution of income between Indonesians and foreigners (including Chinese) as a source of higher standards of living. Under such circumstances, it is not surprising that most Indonesians appeared less development-minded in the early independence years.

It was seven years after the transfer of sovereignty, and over four years after the establishment of a National Planning Bureau with U.N. assistance, that Indonesia was able to produre a development plan in 1956. It seemed then that there were some signs that Indonesia had entered a transitional phase in which economic development had really become a concrete issue of the government. As President Sukarno stated, Indonesia was entering a new phase in her history, a period of "planning and investment". He described the period from the Declaration of Independence to the recognition of sovereignty (1945-1949) as one of "physical revolution", and the years 1950-1955 as the "survival period".[28]

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27 For many years since the Independence, most Indonesians had great hostilities towards the Dutch and the Chinese people, especially in some villages, causing physical danger to lives and properties.

28 B. Higgins, Indonesia's Economic Stabilization and Development, 1957, p. xxi.

In 1952, a National Planning Board consisting of Cabinet Ministers and presided over by the Prime Minister, was established to make plans and to lay down principles for building and developing a sound national economy. A National Planning Bureau was established under the Board with the purposes to review, revise, and integrate the basic plans which were prepared by the various ministries, into a national investment budget. The Bureau serving as the executive unit of the Board had administrative responsibilities with respect to the investment budget. The National Planning Bureau was assisted by a group of foreign experts provided by the United Nations, and also had assistance of a sizable team of American engineers.

The Indonesia's Five-Year Development Plan (1956-1961) was finally completed by the Bureau and presented to the Cabinet for approval in May 1956, but it did not obtain formal Parliamentary approval until 1959.

Why did it take so long to complete a development plan? First of all, it was because there were delays in the recruiting of foreign experts. Then there were other administrative problems such as the lack of clear-out and effective direction, the lack of clearly defined relationships of the Bureau to other government agencies and to the team of American engineers. Although all of these problems were being overcome in 1955, the lack of detailed knowledge about the Indonesia resource pattern, and the continued inter-party conflict concerning the basic economic and social goals and the relationship of Indonesia to the outside world were other basic difficulties which the Working Party had to face.

The plan called for net investment of Rp. 6 billion per year, or 6 per cent of national income. Of the total investment of Rp. 30 billion over the five years[29], Rp.12.5 billion were to be invested by the Central Government, of which 13 per cent was allocated to agriculture, 25 per cent to industry and mining, 25 per cent to power and irrigation, 25 per cent to transport and communication, and 12 per cent to education, welfare, and information.[30] Based on an estimated I.C.O.R. of 2:1[31] and an estimated population growth of 1.7 per cent, it was hoped that this plan would yield an annual increase in national income of 3 per cent and a per capita increase of 1.3 per cent. 40 per cent of the increase in national income was to be allocated to capital formation, leaving 60 per cent for raising living standards.[32]

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29 B. Higgins, Indonesia's Economic Stabilization and Development, p. 51.

30 Ibid., p. 178.

31 National Planning Bureau, "A Study of the Indonesian Economic Development Scheme", Ekonomi dan Keuangan, Indonesia, Sept. 1957, p. 602. I.C.O.R. means incremental capital-output ratio. It is used in economic planning to show the ratio of total net investment to the consequent increase in national income.

32 B. Higgins, Indonesia's Economic Stabilization and Development, p. 49.

Unfortunately, since the beginning of the plan, Indonesia has never ceased suffering from various hardships and difficulties which were so complex in nature that the plan was retarded from being really implemented. First of all, the Government's absorption with the problem of unification, the anti-Dutch campaign, and the rebellion, in terms of managerial talent and energy of the nation's leaders, was an important cause. Purely economic factors were the strong inflationary pressures and the decline in exports, which have resulted in the draining of foreign exchange reserve and import cutting of raw materials and capital goods. Furthermore, the problem of slow, complicated, and inefficient administrative procedures has also hampered the execution of the plan. It is reported that the plan has failed to achieve its goal.[33] However, it should be admitted that the planning effort has yielded some qualitative results in the form of increased awareness and experience concerning planning development.

In January 1961, a new Indonesia's Eight Year Development Plan from 1961 to 1969 began when President Sukarno swung the first ceremonial hoe to lay the cornerstone for the building that will house and exhibition of the Plan's

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[33] National Planning Council, Report on the execution of the Five-Year Development Plan 1956-1960, Djakarta, Sept. 1962.

blueprints.[34] The Plan was drafted by the Indonesian National Development Council which was established in July 1959 with representatives of political, regional and functional groups. The Plan, as specifically requested by the President, includes economic as well as social and cultural development, and aims at the establishment of an Indonesian socialist society which should guarantee a job for each according to his ability, sufficient need of daily life, old-age security, and high cultural and spiritual life of the people.[35] Based on these principles, the Council has emphasized the production of consumer goods, better distribution of daily necessities, development of agriculture and basic industries, as well as the encouragement of education and research. Also, all important sectors of the economy should be reserved for government activities, private enterprise should play only a limited role.

The development projects are divided into two major categories, with A projects forming the development plan and B projects as source of revenue to finance A projects. A Projects reveal the emphasis of the Plan, with 45 per cent of the total investment for the production of industry, food-

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34 Guy J. Pauker, "Indonesia's Eight-Year Development Plan", Pacific Affairs, Vol. XXXIV, No. 2, Summer 1961, p.116.

35 National Planning Council, National Overall Development Plan 1961-1969, Djakarta, 1961, p. 12-13.

stuffs, clothing, and pharmaceuticals, 25 per cent for distribution and communication and with the rest for education, people's welfare, security, finance, research and government. The total amount of investment over the eight year period is estimated at Rp.240 billion, or Rp.30 billion a year. At the estimated national income of Rp.236,000 million in 1960, annual investment will be at 13 per cent of national income.[36] The Plan assumes that half of the total investment needed will have to be in foreign exchange and the other half in rupiahs.

Prof. Pauker commented that the Plan was not very encouraging[37], because at an estimated incremental capital-output ratio of 5.3:1[38], and with 13 per cent of national income for investment, total national income would increase

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36 Embassy of the Republic of Indonesia, Indonesia's National Over-all Development Plan, Information Section, Ottawa, Ontario, 1961, p. 3-5.

37 Guy J. Pauker, Op. Cit., p. 130.

38 This estimated incremental capital-output ratio of 5.3:1 by the Development Council is certainly much higher than 2:1 for the Five-Year Plan as was estimated by its predecessor - the Planning Bureau. The I.C.O.R. of 2:1 was based on the experience of the capital-cheap investment during the pre-plan period; and had often been commented as too low for Indonesia. However, this new I.C.O.R. of 5.3:1 for the current plan may not be too high either, in view of the large percentage of resources devoted to the capital-intensive investment of industry, and other projects of transport and communications, education, culture, welfare, and security, which usually cannot be expected to yield substantial quick results.

by only 2.4 per cent a year. While population increase is assumed to be 2.3 per cent, the net increase in per capita income would at best amount to 0.1 per cent. As recognized by the Council, in terms of Indonesia's needs, the Plan is a modest, fairly realistic one. But the important question is whether the Plan can really be implemented. In view of the present low level in agricultural export crops and food production, declining domestic industries, and continued government budget deficit, while population grows at an alarming rate, one has no doubt about the difficulties which the Plan has already encountered. A recent report stated that the first year of the Plan ended December 31, 1961 with few concrete results.[39]

Looking at the Indonesian economy which has been for many years showing signs of long-term stagnation and decline the firm establishment of an effective economic plan is badly needed in order to acquire a sustained push in the country's economic development. Although in terms of planning techniques, the present Plan may have much to be desired, its official execution is already a significant step forward. If fully implemented, the Plan can make a major contribution to Indonesia's progress. But success of

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39 U.S. Dept. of Commerce, "Economic Developments in Indonesia 1961", World Trade Information Service, Part 1, No. 62-32, April 1962, p. 2.

the current Plan depends much upon an integrated approach to all projects, and upon an adequate administrative machinery and proper co-ordination of the responsible organizations for carrying them out.

CHAPTER II

FINANCIAL INSTITUTIONS AND VOLUNTARY SAVINGS

1. The Role of Financial Institutions

Financial institutions in most underdeveloped countries are still at an early stage of development, though there has been a considerable improvement in recent years. However, the role they play in the countries' economic development is, beyond doubt, the most significant one. Through the appropriate operation of these institutions much of the savings could be mobilized and channelled into investments, thus helping economic development of the countries.

Many of the underdeveloped countries are predominantly agrarian societies, money does not play the same pervasive role as in advanced countries. Agricultural products tend, in substantial part, to be of a subsistence rather than market character. Barter transactions are more common than purchases and sales in many rural areas of these countries. Moreover, the banking habit is not as yet widespread even in the monetary of the economy. A United Nations' report pointed out that many of the central banks in South-East Asia were established only since the end of World War II[1], mainly as the result of newly acquired

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1 United Nations, ECAFE, Mobilization of Domestic Capital in Certain Countries of Asia and the Far East, Bangkok, 1951, p. 15.

political independence. However, with the exception of a few non-self-governing territories, nearly all underdeveloped countries to-day have central banking facilities. Most of these central banks are fully owned by the governments, and are provided with unusually wide and flexible powers in the hope of enabling them to pursue a more purposive and effective monetary policy.

The principal objectives and responsibility of central banking is to seek and maintain reasonable financial stability through the control of the volume, character, and cost of money supplies in such a manner as to conduce to healthy levels of employment, national income and economic development.[2] This is the primary contribution that the central bank can make to the promotion of economic development in underdeveloped countries. But, as Arthur I. Bloomfield pointed out: "Its efforts need not, and in fact should not, stop here". "The majority of central banks in underdeveloped countries have, in actual practice, adopted a variety of measures designed more actively to promote the over-all development of their economies"; and "they should not necessarily be evaluated in term of the standards and criteria applied in the more developed ones".[3]

[2] Ibid., p. 18.

[3] Arthur I. Bloomfield, "Some Problems of Central Banking in Underdeveloped Countries", The Journal of Finance, May, 1957, p. 197.

The central bank can make a great contribution to the sound development of financial institutions for the increasing and channelling of savings. It can provide supervision of commercial and savings banking institutions, encourage and assist them to extend their branches into rural areas of the country and thus bring banking facilities to a larger population. In view of the relatively limited use of financial institutions, and the existence of a considerable amount of unorganized money and capital markets in these countries, this role is of basic importance in the mobilization of domestic resources. Through selective credit control applied to the banking system, and through help in establishing and supporting developmental institutions, it can also influence the direction of real resources toward development ends. Finally, the central bank may also serve as adviser to government in fiscal policy, or may be given responsibility of exchange and import control.

Beside the central banks, financial institutions include commercial banks, special savings banks, postal savings institutions, co-operative institutions, insurance companies, and special corporations for long-term finance, and are concerned with either the money market or the capital market. Money market consists of all sources of short and medium term credit and mainly refers to commercial banks, while the capital market is concerned with long-term finance with sources usually from corporations, savings institutions, insurance funds, and some from co-operative institutions. The development of such organizations is the principal means of mobilizing savings and financing investments.

Commercial banks are much better developed than other types of financial institutions in underdeveloped countries. This was due originally to the pioneer establishment of branches of some well-known foreign banks. Foreign banks concentrate mainly on foreign trade finance, while domestic private banks engaged mostly in short-term lending. Generally the commercial banks' financial assistance to industry and agriculture is rather limited. In view of the fact that nearly all of them operated in urban areas, much consideration should be given to the need for a deliberate programme by commercial banks to attract savings or time deposits from the rural population.

Co-operative institutions in underdeveloped countries such as South East Asia are still not very successful. But increased attention to the co-operative movement has been given by nearly every country. For the most part this is motivated by the need to provide better credit facilities and the desire to mobilize the savings of their members in rural areas. This is also considered an important means of increasing domestic resources to meet the long-term investment needs of agriculture. But other institutions have also been developed in recent years to provide agriculture credit, such as the Agricultural Development Finance Corporation and the Agricultural Bank in Pakistan.

Postal savings, as well as the savings departments of commercial banks or special savings banks are the most familiar institutions for accumulating funds for relatively long term investment. Postal savings facilities are designed primarily to encourage thrift among middle and low income groups, and to provide funds for the central government. These savings banks, whether postal or otherwise, have a relatively widespread network of offices in most of the underdeveloped countries.

Life insurance companies constitute important agencies for the mobilization of the savings of the middle income groups. They develop savings habit and make funds available for long-term investment. Again, insurance facilities are confined only to urban areas, and, except in some places, for example, India, Ceylon, Singapore, and Hong Kong in Asia, their developments are not very significant. Stock Exchange is another supplement to financial institutions which enables individual investors to contribute their savings and then participate in public enterprises. In most underdeveloped countries, stock exchange suffers from a narrow market, and is still not widely used.

As far as long-term industrial finance institutions are concerned, there is a shortage of specialized private institutions in most of the underdeveloped countries. However, great efforts have been taken by the governments to fill this gap by the establishment of financial institutions for the provision of long-term finance for industry. For example, both in India and Pakistan, industrial finance corporations have been set up in the late nineteen forties to provide medium and long-term finance for industrial undertakings out of capital that had been mostly subscribed by the governments. Industrial credit and investment corporations have also been established in these two countries recently.

Enough has been said to indicate that various financing institutions act as intermediaries between savers and investors. Through the various facilities they provide, people may be encouraged to save more. But to the extent that the constituent parts of the system are able to create credit, the risk of this power being excessively used should be avoided by proper control and supervision, and thus contribute effectively towards the growth of the national economy.

2. Financial Institutions in Indonesia

The financial institutions of Indonesia consist of a central bank, a considerable number of commercial banks, savings banks, specialized credit institutions, pawnshop service, and stock exchange. The components of commercial banks include a core of state banks, national private banks, and a network of foreign banks.

Indonesia established her real central bank (Bank Indonesia) only in 1953, but the important central banking functions were partly performed by the Java Bank which was established in 1828 as a private share holders' bank. The Java Bank, before its transformation into Bank Indonesia, acted as note-issuing agent, banker to the government, and performed commercial banking functions as well. The Bank's duties to the government were defined in its statute. Since 1953, Bank Indonesia also has continued to do a significant amount of commercial business. Its central banking functions currently include the exclusive right to note issue and its role as the primary source of direct credit for the government.

Before the transfer of sovereignty, commercial banking in Indonesia was conducted predominantly by Netherlands interests, in addition to other foreign banking institutions. But to this day, Indonesian and government participation in this field has been significant. Strenuous efforts have been made by the government to increase the number of national private banks. Up to the end of December 1959, there were 95 registered national private banks, increasing from a number of 75 in 1955.[4] On the contrary, foreign banks operations have been subjected to some restrictions, and hampered by partial nationalization by the government in the anti-Dutch campaign that began in December 1957. These foreign banks have provided commercial banking services for the foreign community and have been primarily concerned with the financing of foreign owned estates, trades, and other enterprises, but do not engage in long-term industrial or mortgage finance.[5]

Among governmental institutions, there exists some specialization of functions. The Bank Negara Indonesia, which was founded in 1946 to be a bank of issue was re-established by the Emergency Law of February 1955[6], with a special task of promoting national economy in the sphere of trade in general and export-import in particular. To that end, the bank's activities now comprise the granting of

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4 Bank Indonesia, Report of Bank Indonesia 1959-1960 p. 93.

5 United Nations, Economic Bulletin for Asia and the Far East, Vol. 1, No. 1, Bangkok, August 1950, p. 25.

6 Bank Indonesia, Report of Bank Indonesia, 1954-55, p. 76.

short-term and long-term credits to Indonesian importers and exporters to enable them to take part in foreign trade. The Bank Industri Negara was established in 1952 with the purpose of rendering assistance in the development of manufacturing, mining and agricultural (mainly sugar-making) industries. Thus it is concerned with the extension of long-term credit to these Indonesian industries. The Bank Rakjat Indonesia was established in 1946 to replace the Dutch colonial Algemene Volkscrediet Bank in extending credit, primarily in the rural areas. Its function was redefined in 1951 to extend credit to medium-sized and small commercial and industrial firms. As of January 1, 1957, the Bank was granted the statute of a foreign exchange bank[7]. In doing so, it was expected to provide more adequate facilities regarding overseas transactions. The Bank Tani dan Nelajan (Bank for Small-holders and Fishermen) was set up in 1957. The objectives of this Bank comprise the assistance to small-holders, farm-hands and fishermen in their production of agriculture, stock-breeding and fishery, as well as the guiding of the process and sale of their products in order to achieve a higher standard of living. Finally, the Bank Umum Negara is another newly established bank of the government. It was established to cope with all activities of the Nationale

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[7] Bank Indonesia, Report of Bank Indonesia 1956-1957, p. 92.

Handels-bank N.V. which had been nationalized in 1959[8]. It was entrusted with the same task of engaging in foreign exchange banking activities.

Specialized governmental lending institutions in Indonesia are the Desa Lumbungs (paddy banks), Desa Banks (village banks), and Jajasan Kredit (credit foundation). Both Desa Lumbungs and Desa Banks were originally developed in the early twentieth century out of the traditional village granary. They raised their resources or capital from the village community and then loaned paddy or capital to small cultivators, traders, and craftsmen. These paddy banks and village banks had been in a disorganized state since the end of World War II. They were reopened in August 1952 when the government intended to intensify their activities in the realm of granting credits to small-holders[9]. However, it was expected that these concerns would be conducted on co-operative lines. The Jajasan Kredit was primarily only a guarantor agency. It helps in providing credits for approved enterprises through the state banks without actually itself performing banking business. In 1956, it was reorganized and renamed "Jajasan Lembaga Djaminan Kredit", abbreviated L.D.K. (Foundation Credit Guarantee Institute)[10]. Since then, it has

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8 Bank Indonesia, 1959-1960, op. cit., p. 92.

9 Java Bank, Report of the Java Bank 1952-1953, p.80-81.

10 Bank Indonesia, Report of Bank Indonesia 1955-1956, p. 88.

acquired more power and has functioned as a "credit guarantee board". All credit applications on behalf of the Indonesian industry are granted exclusively through this institution.

In addition to these institutions with commercial banking functions, the government operates a postal savings bank and a state pawnshop service. The postal savings bank is a continuation of the original Dutch system established in 1898[11]. Progress since the end of World War II has not been fast. However, it has had some success in collecting small-scale deposits throughout Indonesia in recent years. The total of savings with the Post Office Savings Bank (with its 899 branches in 1959) and with the 6 biggest private savings banks increased steadily since 1954, and showed a total of Rp.536 million in 1959[12]. From the viewpoint of providing credit, government pawnshops in Indonesia have played an important role. They were started as early as the village banks, but became dislocated in the early postwar period. After 1951, the aggregate of pawnshops continued to increase to a total of 440 units by the end of 1959[13].

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11 United Nations, Mobilization of domestic capital in certain countries of Asia and the Far East, p. 156.

12 Bank Indonesia, 1959-1960, op. cit., p. 97.

13 Ibid., p. 96.

The final component of the financial system in Indonesia is the stock exchange in Djakarta, which commenced business on January 4, 1952. The stock exchange, by providing facilities for ready sale and purchase of stocks and shares, has contributed the growth of investment habit. However, as the Governor of Bank Indonesia indicated: "Stock exchange business in Indonesia is still of little significance;"[14] improvement in recent years has been slow.

Relatively speaking, Indonesia does not suffer from the lack of financial institutions, it suffers, rather, from the deficiency in co-ordinating the operations of the governmental financial institutions. Dr. D.S. Paauw expressed his view in this way: "Indonesia is plagued by a proliferation of banking institutions resulting in considerable duplication of lending functions, and extension of credit with little co-ordinated monetary control."[15] In fact, practically all funds which are available to the indigenous Indonesian banking system are obtained from, or partly supported by, government subscription to capital, government advances or deposits, and advances from Bank Indonesia. For many years,

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14 Bank Indonesia, Report of Bank Indonesia 1953-1954, p. 75.

15 D.S. Paauw, "Financing Economic Development in Indonesia: Public and Private Mobilization of Voluntary Savings", Ekonomi dan Keuangan Indonesia, April 1955, p. 205.

credit expansion of these Indonesian banking institutions has been and still remains an important source of inflationary pressures on the Indonesian economy.

For a sound financing of economic development, it is usually argued that the banking system should not emphasize the quantitative aspect, because too many small and inefficient banks will weaken monetary control. It is advisable to have a small number of strong commercial banks, with many efficient branches scattered throughout the country. A country like Indonesia is considered to have "too many" banking institutions[16]. It is apparent that the existence of financial institutions is indispensable, their efforts in mobilizing savings are still significant, but their effectiveness in the allocation of resources is the most important of all. In Prof. Higgins' words: "Proliferation of savings and credit institutions, then, is no substitute for a genuine increase in savings"[17], or an increase in productivity.

3. Voluntary Savings

The growth of a country's economy depends substantially on the amount of investment, which, of course, has

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16 B. Higgins, Economic Development, N.Y., W.W. Norton & Company Inc., 1959, p. 483.

17 Higgins, Op. cit., p. 486.

to be matched by real capital. Apart from government taxation and foreign capital and assistance, another important source is voluntary domestic savings. Economists usually pointed out that voluntary savings cannot go far toward financing the capital requirements for raising output per capita[18]. This point is especially true for economically underdeveloped countries where the rate of net capital formation must be doubled or trebled if self-sustained growth is to be achieved.

In most underdeveloped countries, the volume of voluntary savings supplied from current income is small; moreover, the existing financial institutions are not very successful in mobilizing such savings and transferring them to investors. It is often argued that the rate of voluntary savings in these countries is low because their incomes are low. Most of the population live close to subsistence level; ~~there is~~ little, if anything, c an be saved. Furthermore, a rapidly growing population absorbs almost immediately any increase in real income. Countries which are blessed with higher average income levels will certainly tend to save a larger proportion than those with lower income levels.

However, we are aware that the volume of saving does not depend on the amount of income alone. Knowledge of

18 C.P. Kindleberger, Economic Development, N.Y., McGraw-Hill, 1958, p. 198.

savings and investment opportunity, efficiency of financial intermediaries, social and economic stability, incentives and customs and many other conditions are important determinants of savings. Thus, besides minimum physiological requirements, volume of savings is influenced by psychological and sociological factors. Historically, many of the developed countries in Europe and North America started the process of capital formation from per capita income levels not much higher than the current poor countries[19]. W. Arthur Lewis said in his book: "No nation is so poor that it could not save 12 per cent of its national income if it wanted to; poverty has never prevented nations from launching upon wars or from wasting their substances in other ways"[20]. As an example, the Indian National Sample Survey estimated that 7 per cent of all the rural expenditures in India were for ceremonial purposes - funerals, birth, celebrations[21].

As a matter of fact, not every person in underdeveloped countries lives on subsistance level. Some of

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19 J. Ahrensdorf, "Have the Cake and Eat it too? Saving, Inflation, and Economic Development". Ekonomi dan Keuangan Indonesia, Oct., 1953, p. 613-614.

20 W. Arthur Lewis, The Theory of Economic Growth, Illinois, Richard D. Irwin, Inc., 1955, p. 236.

21 Charles Wolf & Sidney Sufrin, Capital Formation and Foreign Investment in Underdeveloped Areas, Syracuse, Syracuse University Press, 1955, p. 11-14.

them are very rich, and some of them receive incomes which permit adequate consumption and still have some left for other purposes. This disparity of income may have a favorable effect on economic development if the luxury consumption of the higher income groups can be eliminated, and savings channelled into productive activities. In Japan, for example, in her early period of economic development, unequal distribution of income had contributed much to the savings ability for financing[22]. People with higher incomes are easily affected by the desire of social prestige by means of conspicuous consumption. Consumption pressures of the people seem to shift upward, affected by what Ragnar Nurkse termed the "international demonstration effect"[23] which results from the contact with consumption patterns of advanced economies.

Incomes in excess of consumption of the higher income groups are usually attracted by the high interest rate of the unorganized money market to finance low-income consumers, farmers, or retailers. In this case, voluntary savings performed by the surplus spending units are offset by the dissaving of deficit consumers or by the small traders, and thus

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22 Daniel Lloyd Spencer, "Japan's Pre-Perry Preparation for Economic Growth", The American Journal of Economic and Sociology, Vol. 17, No. 2, Jan. 1958, p. 195-215.

23 Ragnar Nurkse, Problems of Capital Formation in Underdeveloped Countries, Oxford University Press, 1953, p. 57-70.

reduce the amount of savings available for more productive uses. In Indonesia, the unorganized money market which consists mainly of individual money lenders (mostly Chinese and Arab) and small firms, is a hindrance to the prospects of mobilizing savings through public and private intermediaries or security market.

Another obstacle to the mobilization of voluntary savings resulted from the traditional habits of hoarding. Many Indonesians, as a majority of people in other underdeveloped countries, learn to be thrifty[24], and keep part of their present consumption for future use. But the problem in Indonesia is more intractable, because hoarding is not ordinarily held in the form of currency, but usually in the form of jewelry, precious metals, livestock, or other physical assets. Savings in this way is considered, especially by the rural people, the most convenient way of storing money safely. The choice as to what things to keep usually depends on how much money is available. They may buy a cow, a gold ring, some cloths, or perhaps a few chickens. Savings as such are largely static and very little returns can be expected from them. The things they own are a potential source of capital, and when the need arises the family sells

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24 It is sometimes believed that the Indonesian are not as thrifty as the local Chinese, most of whom immigrated bare-handed, and started their business by the virtues of thrift and hard work.

or pawns them. Generally, savings stored in valuables are looked on as funds prepared for a specific purpose such as building a new house, giving a wedding or a religious ceremony, but very seldom as capital to be invested in business.[25] Among people of the lower income groups, primarily in the rural areas, there exists the lack of experience in holding small assets in terms of deposits as well as little sensitivity to the interest-earning aspect of deposits. Holding of one's assets in the form of bank deposits is considered to have involved distinct disadvantages. To them, a gold bracelet, or even a piece of cloth, can easily turn into cash by selling it or putting it through the village pawnshop without really selling it.[26] Furthermore, the reliance on the traditional spirit of family and village assistance to finance their incidental needs has more or less weakened the general inducement to save.

Voluntary savings mobilized through financial institutions in Indonesia are shown in Table II as time and savings deposits. Statistics for time deposits accumulated through co-operatives are not available. The ratio of total time and savings deposits to total money supply ranged from 2.1 per cent to 4.2 per cent in 1953-1959. Apparently, the

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[25] Alice G. Dewey, Peasant Marketing in Java, The Free Press of Glencoe, Inc., 1962, p. 94-99.

[26] Ibid., p. 98.

TABLE II

Voluntary Savings Mobilized by Intermediaries
1953-1959

(million Rp.)

	1953	1954	1955	1956	1957	1958	1959
Time and Savings Deposits:							
Combined figures of Bank Indonesia, state banks & foreign banks	119	153	212	180	170	185	79
Private Indonesian commercial banks	15	74	75	115	215	216	127
Postal savings banks and private savings banks	141	180	214	259	339	423	536
Total -	275	407	501	554	724	824	742
Money Supply:							
Currency	5,218	7,474	8,647	9,373	14,091	19,872	26,383
Demand deposits	2,269	3,643	3,857	4,021	4,822	9,495	8,500
Total -	7,487	11,117	12,234	13,394	18,913	29,366	34,883
Time and savings deposits as percent of money supply	3.7%	3.7%	4.2%	4.1%	3.8%	2.8%	2.1%

Source: Data obtained from annual edition of the Report of Bank Indonesia, 1953 through 1959.

ratio is alarmingly low even when compared with other underdeveloped country such as India which has 29 per cent in 1957 and 43 per cent in 1958[27]. The ratio seems to rise for a few years and then falls again to even lower than before, at only about 2.1 per cent in 1959. This is because the increases in savings are being offset by rapid expansion of the total money supply. In fact, total deposits with the government, foreign and private commercial banks have not been impressive, only the postal savings banks and private savings banks have shown signs of constant increases. It is clear, then, that the Indonesian banking institutions have not been able to mobilize voluntary savings on a significant scale.

4. Measures to Increase Voluntary Savings

Although the scope of voluntary savings may be less significant in most underdeveloped countries, it does not imply that the role of voluntary savings can be completely ignored. Mobilization of voluntary savings has an important effect in restricting consumption and redirecting savings of the people, especially those in the rural areas, during the early stages of economic growth[28]. Thus, from the viewpoint

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27 Figures computed from: Government of India, India 1960, Delhi, Government of India Press, 1961, p. 235-237.

28 Higgins, Op. Cit., p. 482.

of financing economic development in Indonesia, it is important that the banking system should be encouraged to increase the supply of real savings which are to be transferred to public and private investors. Yet, success in increasing the flow of voluntary savings does not depend on intermediaries alone, but on the various measures to remove obstacles and to promote the habit of saving through financial institutions.

First of all, the people's fear of putting savings in the bank as bank deposits should be removed. In Indonesia, the unpleasant experience of inflationary pressure for the last ten years is clearly related to the low level of deposits. Therefore, inflation must be eliminated by more effective monetary policies and by reducing government deficit spending. The fear of losing value of one's deposits would also be relieved by the guarantee of the same value of a number of basic commodities. Facilities to attract savings should be widespread and easily accessible. Great efforts must be made to gain the confidence of the potential depositers.

An experience undertaken by the provincial government of Central Sumatra in establishing premiums in the form of savings deposits for prompt payment of loans to Desa Banks might be generalized to promote savings habits through the use of time or savings deposits[29]. Voluntary savings can

29 Paauw, Op. Cit., p. 214.

also be collected by selling government bond issues through banking institutions or stock exchange. These bond issues could possibly be more attractive to the people if linked with certain projects of local interest.[30]

The removal of the high disparity of interest rate between the unorganized money market and the banking institutions is unlikely to be successful, because it is difficult for the banks to provide a much higher interest rate for deposits, and it is also difficult to make the petty lenders abandon their profitable business. Perhaps, a more feasible solution would be to place restriction upon such activities by strict licensing requirements, and at the same time provide the people with better credit facilities.

Since voluntary savings are usually frustrated by social and cultural factors, it would seem that an effort to change the saving-income ratio of the people would demand an effort to change the general pattern of mores and social structure. Unfortunately, the results of propaganda or other officially sponsored exhortations towards such change have not been very promising. Therefore, policies to increase savings voluntarily might well be the promotion of local institutions which already have popular support. An example of these types of institutions known on Java as "Arisan"

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[30] United Nations, <u>Domestic Financing of Economic Development in Underdeveloped Countries</u>, New York, 1949, p. 2.

(literally meaning co-operative endeavor or mutual help) and termed "rotating credit association" by C. Geertz[31], is believed to be a very useful way of promoting domestic voluntary savings. On the basic belief that these "Arisans" are popularly trusted by many Indonesians, Geertz believed that it could be oriented more specifically to finance economic development by the government by organizing pools for the purchase of capital goods in such forms as agricultural machinery, machines for cottage industry, or raw materials in scarce supply[32]. The pooling of the saved funds will in this way transfer more directly to investment purposes from individual hands who might have dispersed them in less productive activities. In a country like Indonesia where the majority of people are rooted in traditional mores, such an instrument if intelligently and vigorously promoted,

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31 Clifford Geertz, Jr., The Rotating Association: An Instrument for Development, Center for International Studies, Massachusetts, Institute of Technology, Cambridge, November, 1956. Arisan consists of "a lump sum composed of fixed contributions from each member" which is "distributed at fixed intervals and as a whole, to each member of the association in turn". It is ordinarily done to finance anticipated consumption expenditures, particularly communal feasts, or to provide trade capital. This rotating credit association is also found in many other places in Asia. P. 3-5.

32 Ibid., p. 46.

might be successful in solving part of the problem of increasing voluntary savings for economic development. It is usually suggested that co-operative institutions should be developed in underdeveloped countries for mobilizing and directing domestic voluntary savings[33]. Thus, more strenuous efforts should be made by the government towards such movement in order to yield more fruitful results in Indonesia.

[33] A. A. Pepelasis & Others, Economic Development: Analysis and Case Studies, N.Y., Harper & Brothers, 1961, p. 110-111.

CHAPTER III

GOVERNMENT FINANCING

1. Deficit Financing and Inflation

In many underdeveloped countries, government expenditures grew substantially with the increase in population, urbanization and growth of the economy. Government revenue, on the other hand, usually failed to increase in proportion. As a result, deficit financing was relied upon to take care of a substantial part of government outlays. "Deficit financing" is defined by G. Patterson[1] of Princeton University as "a net increase in the amount of money in circulation, such increase being the result of conscious governmental policy designed to bring about economic activity that the officials believe desirable and that otherwise would not have taken place". Thus, such net increase of money is assumed not to be offset by taxation or tight bank credit.

As shown in Table III, budget deficits have been a feature of fiscal operations in almost all the countries of Asia and the Far East. By budget deficit, we refer to the

[1] Gardner Patterson, "Impact of Deficit, Financing in Underdeveloped Countries", Journal of Finance, Vol. XII, No. 2, May 1957, p. 178.

TABLE III

Budget Deficit of Countries in
Asia and the Far East
1953-1958

Country	1953	1954	1955	1956	1957	1958
	(% of government expenditure)					
Burma	11	26	15	42	20	31
Ceylon	14	-10	-11	-3	10	11
China: Taiwan	27	27	30	28	32	34
Federation of Malaya	28	26	8	12	12	22
India	20	24	29	31	33	36
Indonesia	13	23	13	8	20	34
Japan	17	15	21	12	11	15
Korea, Southern	47	47	47	42	53	48
Laos	29	43	63	58	42	64
Pakistan	20	29	14	21	38	30
Philippines	14	6	9	15	5	4
Thailand	27	27	23	15	26	17
Viet-Nam	29	68	67		40	
	(% of gross national product)					
Burma	2.2	7.5	4.1	10.4	4.8	8.7
Ceylon	3.5	-2.0	-2.1	-0.8	2.6	2.8
China: Taiwan	6.2	7.1	8.1	7.8	9.4	11.2
Federation of Malaya	3.5		1.5	2.4	2.2	
India	2.0	2.9	4.0	4.3	5.3	6.0
Indonesia	2.4	3.8	1.7	1.1	3.0	6.7
Japan	4.5	3.9	5.5	2.9	2.6	4.1
Korea, Southern	6.2	8.1	7.4	6.0	11.9	11.6
Pakistan	2.4	3.5	1.6	2.3	6.0	4.6
Philippines	1.6	0.7	1.1	1.8	0.6	0.4
Thailand	4.4	4.8	3.2	2.1	4.3	2.5

Source: United Nations, Economic Survey of Asia and the Far East, 1960, Bangkok, 1961, p. 107.

excess of total government expenditure over government revenue. The impact of a budget deficit on the national economy depends on the method of financing employed. It is sometimes believed that budget deficits, if kept within certain limits, need not be inflationary. It is true that if the deficit is financed by borrowing the idle savings of the people, or from the proceeds of a foreign loan, or by drawing on foreign exchange reserves, inflationary pressure can be substantially reduced. But very often, budget deficits are financed by borrowing from the central bank. This action is usually followed by secondary credit expansion to the private sector by commercial banks, and results in an expansionary influence on money income and effective demand. Unless foreign resources are available, or production has increased sufficiently and fast enough to meet the increased effective demand, competitive spending between the government and the private sector on the existing resources, will in due course result in a rise of price. The method of financing budget deficit by money creation is therefore fraught with danger of inflation.

An inflationary method of financing is often advocated for newly-developed economics on the ground that it is a measure to counteract hoarding, to transfer real resources from consumption to investment programs desired by the government, and to direct unemployed or under-employed to the production of goods and services. It is believed that if the government's use of money newly created does not exceed the savings in currency hoarded by the people, no serious inflationary pressure is released. Even when prices rise, it is asserted, people will be forced to save by reducing the volume of physical consumption; wage rates will remain lagging behind for sometime and investors or businessmen will make greater profit and increase their savings. Again, it is argued by some that underdeveloped countries have large unemployed or under-employed resources, especially with regard to labour. The extra purchasing power injected by government deficits would induce the use of such resources for increasing production of goods and services.

As we have seen in Chapter II, most people in under-developed countries are poor, and prefer to keep savings in the form of precious metals; the amount of currency hoarded, if any, would not be large enough to be counteracted by deficit financing. In an economy where the level of voluntary savings is already low, routine savings become even more unattractive under inflationary conditions, for prople are not eager to hold money but will change it into physical assets. In addition, the wage earning class in many under-developed countries is not very large with the result that even if wages are rigid, resources which can be transferred are limited.

If the increased profits of the investors or businessmen were substantially taxed by the government, or used to buy government bonds, hoarded in cash, or used to pay off past bank loans, then inflation would be very much reduced and real resources could then be transferred to planned investment of the government. But quite often, they are tempted to make speculative and unproductive private investments which offers prospects of inflationary profits. During an inflationary period, manufacturers, merchants, and farmers have a tendency to hoard their outputs in anticipation of further price increases. Such savings, in the form of accumulated inventories and products, will push the economy onto a higher inflationary level. Although the effect of redistribution of income induced by inflation may increase the incentive of the entrepreneurs to invest, such investment, if without discrimination, will compete with the planned sector in the utilization of limited resources.

It is true that there is in underdeveloped countries, a reservoir of under-employed labour. But as Professor Patterson[2] pointed out, the transference of such idle resources seems likely to be limited largely to unskilled workers and, unfortunately, their net increase in production for capital formation purposes may be relatively small. It is

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[2] Gardner Patterson, Op. Cit., p. 180-182.

possible that the value of the new output may be partly offset by the increase in consumption entailed by such employment; and again, the scarcity of trained personnel, skilled labour, machinery and tools, may limit the effective use of the unskilled labour. The difficulty of utilizing the unemployed labour for producing capital goods has also been emphasized in a United Nations' document in these terms: "Since the obstacle to employing this labour is usually insufficiency of capital equipment, surplus labour cannot be employed even to produce consumption goods until some means of financing the creation of this capital equipment is first found"[3]. Therefore, the effectiveness of these unemployed or under-employed resources that can be brought into production by deficit financing must not be overestimated.

Generally, it is considered undesirable under normal conditions to use deficit financing for economic development, because the inflationary pressure it generates upon the economy is prominent. Apart from its arbitrary and anti-social incidence, it creates pressure on the balance-of-payments position, distorts investment, and may also cause a flight of capital. Nevertheless, it may be conceded that, in certain circumstances, inflationary financing of capital expenditure

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[3] United Nations, Measures for the Economic Development of Under-developed Countries, New York, 1951, p. 43.

may expedite capital formation without too many detrimental effects. For instance, during a recession period, a deflationary tendency can be counteracted by money-creating budget deficits, without fear of having an excessive expansion of effective demand. In other cases, in order to avoid excessive inflation from government deficit finance, final products must increase substantially to meet the increase in effective demand. But since excess capacity and the supply of trained personnel are small in underdeveloped countries, and will take time to expand, it is important, therefore, that deficit finance should primarily concentrate on expenditures in fields with quick returns and with a fairly large output-capital ratio. Development of productivity in certain field of agriculture, such as seed improvement, pest control, in the form of community projects will have quick results in increasing production[4]. Under-employed labour can also be used to increase the production of certain cottage industries. Increase of agricultural products is especially important in underdeveloped countries where a relatively large proportion of income is spent on the imports of food. Surplus of agricultural products if any, and output of cottage industries, can be exported and help to

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4 United Nations, "Deficit Financing for Economic Development with Special Reference to ECAFE Countries", Economic Bulletin of Asia and the Far East, Vol. V, No. 3, Nov. 1954, p. 8.

provide additional foreign exchange for other purposes. On the other hand, investment in factory industries of basic facilities, which may generate a longer inflationary pressure, requires a more carefully planned and well controlled programme.

Sometimes it is maintained that the existence of inflationary pressures are inherent in the very concept of development[5]. Development, in the sense of an attempt to raise income and productivity per capita, implies a continuous and persistent demand on the real resourcesof a country and hence produces inflationary pressures. Deficit financing may be desirable to underdeveloped countries if such pressures can be prevented from becoming open inflation. It seems arguable that deficit finance will increase financial source for development, and once the development projects are completed, they would have the effect of increasing production, and higher level of real resources for the financing of development at the next stage.

Yet one should admit that the course of inflationary financing has many pitfalls, and, unless moderately and wisely used, may do more harm than good - as we should see in the case of Indonesia. Once inflationary effects have

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5 Sumitro Djojohadikusumo, "Fiscal Policy, Foreign Exchange Control and Economic Development", Ekonomi dan Keuangan Indonesia, p. 211-213.

rapidly started, anti-inflationary measures, either through fiscal means or direct controls, may prove of little effective use. With rising prices, increasing government expenditure, and limited resources, usually, another increase of the government budget deficit may be necessary.

2. The Indonesian Experience

The experience of Indonesia during the last decade provides an illustration of the behavior of government deficit financing and its impacts upon the economy. Since 1952, government revenue has not been able to cope with expenditure. In addition to its heavy military operations, other factors such as social welfare or administration, have competed heavily with investment. This gap, for the most part, has to be financed by money created through borrowings from the central bank. Consequently, as shown in Table IV, money supply has increased simultaneously from about Rp. 5 billion in 1951 to Rp. 47.8 billion in 1960; the Indonesian economy has been brought to the brink of inflation. The price index of 19 foodstuffs in Djakarta (1953:100) which was 141 at the end of 1955, as given in Table V, more than doubled to 311 by the end of 1959.

During 1953, only about one-seventh of the government deficit was financed by the non-inflationary method of

TABLE IV

Money Supply in Indonesia
(Million Rp.)

End of	Currency	Deposit Money	Total Money
1951 Dec.	3,328.1	1,705.8	5,033.9
1952 Dec.	4,349.2	2,254.6	6,603.8
1953 Dec.	5,217.7	2,268.8	7,486.5
1954 Dec.	7,473.7	3,642.8	11,116.5
1955 Dec.	8,646.8	3,587.2	12,234.0
1956 Dec.	9,372.4	4,021.1	13,393.5
1957 Dec.	14,091.4	4,822.0	18,913.4
1958 Dec.	19,871.7	9,494.5	29,366.2
1959 Dec.	26,383.1	8,499.7	34,882.8
[a]1960 Dec.	34,080.0	13,760.0	47,840.0

Source: Bank Indonesia, Report of Bank Indonesia, 1956-1957 through 1959-1960.

a. United Nations, Economic Survey of Asia and the Far East, 1961, Bangkok, 1962, p. 207.

TABLE V

Index Number of Food Prices

	Twelve foodstuffs (1953=100)		Nineteen foodstuffs (Djakarta 1953=100)		
	Country side of Djawa	Djakarta	Makasar	Medan	Pontianak
1953	100	100	87	100	115
1954	97	106	94	110	120
1955	127	141	135	167	171
1956	153	161	161	168	186
1957	160	177	169	165	180
1958	244	258	232	259	304
1959	271	311	272	338	425
March	259	312	281	310	388
June	256	300	265	345	421
September	266	314	268	344	438
December	307	325	284	357	488

Source: Bank Indonesia, Report of Bank Indonesia, 1959-1960, p. 204.

prepayments required from importers[6]. The rest of the deficit financed by borrowing from the central bank, revaluation of the gold stock, new issue of treasury currency, and reduction in cash balances of government agencies[7]. In 1954, the whole amount of the deficit was almost exclusively financed by borrowing from Bank Indonesia. It was only in the year of 1955 that the budget deficit was almost fully financed by another deflationary method of importers' advanced payments. Although these payments had substantially reduced the money supply and brought temporary relief from the inflationary pressure of the time, its refunds and the deficits of 1956 and 1957 again had to be financed by borrowing from Bank Indonesia[8]. The government deficits, as indicated in Table VI, continued to rise even further in 1958 and 1959, up to the amounts of Rp. 12 billion and Rp. 13.8 billion more than twice the amount in 1957. The main cause for these 1958 and 1959 large deficits was the heavy burden of defence expenditure which stood at nearly one-third of the total government expenditure[9]. The financing of the

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6 These amounted to a forced loan to the government, so long as the volume of imports was maintained at a given level or continued to increase.

7 Bank Indonesia, Report of Bank Indonesia, 1954-1955, p. 63.

8 Bank Indonesia, Report of Bank Indonesia, 1957-1958, p. 83.

9 United Nations, Economic Survey of Asia and the Far East, 1961, Bangkok, 1962, Table 34, p. 213.

TABLE VI

Government Gross Revenue, Gross Expenditure, and Budget Deficits, 1952-1960

(Million Rupiah)

Year	Gross Revenue	Gross Expenditure	Budget Deficit
1952	12,247	15,025	-2,778
1953	13,590	15,658	-2,068
1954	11,539	15,141	-3,602
1955	14,226	16,316	-2,090
1956	18,451	20,015	-1,564
1957	20,571	25,610	-5,039
1958	23,273	35,313	-12,040
1959	30,571	44,350	-13,779

Source: United Nations, Economic Survey of Asia and the Far East, 1956, 1958, 1959 and 1961.

whole 1958 deficit by Bank Indonesia brought the economy up to the peak of inflation since 1953. The situation continued to deteriorate even further in 1959. Although about 60 per cent of the deficit was financed by a substantial devaluation of bank-notes, and only about 26 per cent from Bank Indonesia[10], the deflationary effect on the economy only lasted for a few months. Prices climbed back to an even higher level at the end of the year.

As frequently alleged by the Governor of the Bank Indonesia, the government deficits have been the greatest source of inflationary pressures during all these post independence years[11]. Increased government deficit spending always has expansionary effects upon aggregate demand through adding to demand for goods and services for collective consumption, and also, through inducing new private expenditures from the increased income generated by multiplier effects. Inflationary pressures have also been consistently aggravated by credit expansion of the banking system. The total

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10 Bank Indonesia, Report of Bank Indonesia, 1959-1960, Table 10, p. 60. The devaluation of bank-notes is one of a series of the government monetary measures started in August 1959. Under this devaluation policy, the value of the circulating bank notes of Rp. 500 and Rp. 1,000 was reduced to Rp. 50 and Rp. 100 respectively, that is a 90 per cent cut in the face value.

11 Bank Indonesia, Report of Bank Indonesia, 1955-1956, p. 15; and Bank Indonesia, Report of Bank Indonesia, 1956-1957, p. 11-14.

amount of bank credit granted in 1959 was Rp. 10,340 million, which doubled the amount in 1958 and increased by almost five times in 1953[12].

As shown in Table III, government budget deficits increased from about one-seventh of total government expenditure in 1953 to one-third in 1958; investment outlays were only at about one-tenth of government expenditure in 1953 and 1958 (see Table VII). Table VIII shows that when comparing the years 1951 and 1958, investment as a percentage of gross national product was reduced both in the public and private sectors. Therefore, it is obvious that government's deficit finance did not give rise to a greater investment in the government sector, and had reduced private investment by its serious inflationary effects. Also, the merit of inflationary finance to utilize the existence of unemployed, or under-employed resources for the purpose of increasing production cannot be justified in Indonesia. For the problem in Indonesia has always been the lack of capital equipment and managerial skill to complement unemployed labor resources.

Needless to say, deficit financing in Indonesia, beginning from 1952, has tended to add to aggregate demand

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[12] Bank Indonesia, Report of Bank Indonesia, 1959-1960, Table 18, p. 84; and Bank Indonesia, Report of Bank Indonesia, 1954-1955, Table 20, p. 76.

TABLE VII

Government's Investment in Percentage
of Government Expenditure
1951-1958

1951	1952	1953	1954	1955	1956	1957	1958
17	13	11	20	17	14	11	9

Source: United Nations, Economic Survey of Asia and the Far East, 1960, Bangkok, 1961, p. 72, Table 25.

TABLE VIII

Allocation of Gross National Product in Indonesia
1951 and 1958

(Per cent)

Year	Domestic Sector					Foreign Sector
	Non-consumption				Consumption	
	Govt. Current Outlay	Govt. Capital Outlay	Private Investment Outlay	Total	Private Consumption Outlay	Net Exports of Good & Services
1951	13	3	7	23	75	2
1958	18	2	3	23	76	1

Source: United Nations, Economic Survey of Asia and the Far East, 1960, Bangkok, 1961, p. 59, Table 20.

without generating much increases in output. Inflation for all these years has led to a substantial amount of misallocation of investment resources as they have been channelled to financing inventory hoards and speculative activity rather than to capital formation. In the industrial and estate agricultural sectors of the economy, there have been persistent demands for increased wages. Man-hours lost during strikes were reported to have totalled from less than 1 million in 1952, to 4 million in 1953, and 7 million in 1956, though the amount has dropped to only 219 thousand in 1959[13]. The increases in wage costs then, have adverse effect on the expansion of export earnings and export duties. Inflation in Indonesia has also hampered economic development by putting pressure on balance of payments, and has forced the government to severe reductions in foreign exchange and gold reserves in an effort to restrain the upsurge of domestic prices.

In view of the fact that the Indonesian economy has so much been deteriorated by inflation, the government deficit must be eliminated in the country's searching of sources for economic development. As pointed out by Leon Mear: "A small inflation may be helpful to development, but the

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13 Bank Indonesia, Report of Bank Indonesia, 1959-1960, p. 213, and Bank Indonesia, Report of Bank Indonesia, 1954-1955, p. 159.

inflation in Indonesia seems to have worked more for stagnation", and that "a first essential" for Indonesia "is a reasonable budgetary balance"[14].

3. The Role of Taxation

Domestic financing of economic development requires increased total domestic savings (public and private) and the transfer of spending from private non-developmental investment to developmental activities. As indicated in the previous section, the method of inflationary finance with an intention to transfer real resources to the government has its self-defeating effects. Private voluntary savings, including purchasing of government bonds, are also characteristically insufficient in most underdeveloped countries. Taxation, therefore, remains as the only important alternative for reducing private consumption and transferring real resources to the government for economic development.

Domestic enterprises in most underdeveloped countries tend to limit themselves to operating rather than to expanding the existing productive machinery. Incentives to save and to invest in more productive purposes are not great enough to attract large amounts of personal or business

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14 Leon Mears and Adamantios Pepelasis, Economic Development, New York, Harper & Brothers, 1961, p. 452 and p. 464.

savings. The persistence of stagnation with low rates of saving and investment requires strong stimulants provided by the government to raise the economy's rate of investment without inflation. The use of increasing compulsory public saving seems to be essential in producing greater revenues for the government to undertake sound investment projects. This method of increasing government revenue may have significant secondary effects of influencing the rate of private saving and directing private investment into developmental enterprises, through a change of taxation that provides more incentive for the private sector to save and to invest. Yet it is sometimes argued conversely that compulsory public saving through taxation may be self-defeating because it has unfavourable effects on private saving and investment, and may even aggravate rather than alleviate inflationary pressures. This controversal issue sometimes seems to blur the role of tax financing in economic development.

With respect to higher tax levels, the adverse effect is that taxes which fall either on wage earners, on the higher income groups, on businessmen or corporations, will diminish or destroy their incentive to save and to invest. This argument has some prima facie plausibility and needs closer examination. It is very common that people, business-men especially, complain about the adverse effects of taxes. And still to-day, most of the developed economies have maintained a fairly high level of taxation. It is not the general level of taxation, that is injurious to economic productivity; it is rather the sharp steepening of the rates, and the absence of tax discrimination or the ineffectiveness of the tax system. Tax revenues in underdeveloped countries could be substantially increased, without necessarily increasing the tax rates, by improving tax administration and enforcement.

A generally low level of taxation may increase some private savings and investment, and may also increase consumption and speculation. But the lowering of government revenue will have the effect of lowering the national rate of saving and investment, which of course will hamper the country's economic growth. Therefore, it seems desirable to adopt a higher average level of taxation, and devote a good deal of attention to "incentive taxation" in the undertaking to increase tax revenues. The purpose of incentive taxation is to stimulate an increase in the flow of savings and investment or to improve the allocation of capital, land, labour, and entrepreneurship.

Taxes which are designed to encourage personal saving take the form of taxation on spending, such as sales taxes and various commodity taxes. In general, tax rates are discriminated between necessities, amenities and luxuries. Such taxes are aimed at directly curtailing spending

They may reduce the ability to spend by taking money away from the consumers, and they lessen, to some extent at least, the incentive to spend, since tax liability can be reduced by saving more and spending less.

Other positive measures to increase personal incentive to save are the deductions from taxable income allowed for contributions to life insurance premiums, postal saving deposits or the portion of income used to buy securities of certain projects. One other special tax designed to increase personal saving is a compulsory contribution (deduction from payrolls) to a provident fund, such as the old age pension fund which has been successfully utilized in Singapore.

In underdeveloped countries, such as Indonesia, where speculative hoarding of goods and currency is quite high, taxes on such hoarding will have a counteracting offect. A tax with differential rates imposed on all assets, for example, higher rates on cash balances, inventories, and unused land, as well as lower rates on government securities, will encourage the diversion of saving from cash balances to productive investment.

Specific incentives to invest may be provided by tax exemption of certain desired new investments for a number of years. This method, with little variation, has been widely used in Southeast Asian countries, such as Philippines, Ceylon, India, Pakistan, Singapore and Malaya[15]. Another incentive provision is the allowance of higher and accelerated depreciation for fixed investment in approved channels, or special concessions to the reinvestment of profits.

Primarily, the main purpose of collecting more taxes is to allow increased government expenditure without inflation. The argument that an increase in taxes will be inflationary is based upon a misunderstanding between the effects of collecting taxes and the effects of spending them. It is generally accepted that a high government expenditure is in itself inflationary. But an increase in taxation, which cuts the people's income and spending, is certainly deflationary in its effect, no matter what its level is.

Many underdeveloped countries depend to a substantial extent for their revenue on taxation of imports, exports, and foreign exchange. Some of the countries in Southeast Asia, such as Ceylon, Federation of Malaya, Indonesia, Laos, North Borneo, and Thailand, have about one-third to one half of total revenue from foreign trade[16], although its share of revenue is falling in recent years. Export duties usually provide less significant and less steady

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15 United Nations, Economic Survey of Asia and the Far East, 1960, Bangkok, 1961, p. 98.

16 United Nations, Economic Survey of Asia and the Far East, 1960, Bangkok, 1961, Table 35, p. 87.

revenues than import duties, because export trade of most underdeveloped countries are extremely vulnerable to fluctuations. They provide large revenue, however, for some primary products exporting countries during abnormally favorable conditions like the Korean War boom in raw materials. High import duties can easily be imposed on certain luxuries or inessential commodities and yield considerable revenues for the governments. This process will have a restrictive effect on consumer spending. The incomes which would have been spent on imported consumer goods would be left in the hands of consumers for spending in other goods or for saving. Thus, taxes on imports may also help to protect domestically produced goods, assist in improving the balance of payments position, and at the same time, save some foreign exchange for import of more essential goods.

In general, most underdeveloped countries rely more heavily on indirect taxes than on direct taxes of income and wealth. Apart from the taxation of foreign trade, taxation of commodities and services also provides substantial revenue for many countries. In the form of excise and sales taxes, they exert important anti-inflationary effect upon the economy. Income taxes in underdeveloped countries such as most of the Asian countries, are not as significant as in advanced countries. It has been frequently pointed out by the United Nations studies that because of the minimum exemption limits laid down for taxation, personal income tax liability excludes almost all but a fringe at the top of the social pyramid. While the mass of the population remains untouched by the income tax, the small number of the rich who pay the tax usually are able to avoid part of the tax through legal loopholes or through administrative deficiencies[17]. The assessment of company income tax has also not been very significant in many countries. It is possible that part of the government revenue can be increased through effective enforcement of direct income tax. But in view of the fact that a majority of the people's incomes are below the national average, and the practical difficulties in the immediate attempt to expand the scope of the income tax, government revenue from this source is not likely to increase substantially in the near future. However, it is believed that as a long run policy, increased dependence on income taxes, when administration and compliance improve, should no doubt be a goal of most underdeveloped countries to increase government revenues[18].

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[17] United Nations, "Taxation and Economic Development in Asian Countries", Economic Bulletin for Asia and the Far East, Vol. IV, No. 3, 1953, p. 7-10; U.N., Economic Survey of Asia and the Far East, 1960, p. 94-96.

[18] B. Higgins, Economic Development, N.Y., W.W. Norton & Company Inc., 1959, p. 510.

4. Indonesia's Tax Structure and Local Finance

In Indonesia, as in other underdeveloped countries, financing development may have disincentive effects on production and investment, and such effects will vary with the pattern of financing. We have already shown that inflationary finance provides no easy solution to the problem. The only financial instrument that can be used in Indonesia is the selective increase and effective management of taxation with an eye to its effects on incentives.

Table IX provides us with a general picture of the structure of the Indonesian tax system. During the past decade taxes on foreign trade, income taxes, and consumption taxes together, have produced more than 95 per cent of total tax yields. The present tax structure also includes a relatively large variety of minor taxes such as the restaurant tax, the radio tax, the vehicle tax, the slaughter tax, etc. These minor taxes contribute little to revenue, but involve great complexity and annoyance both to the taxpayers and the revenue collectors. Most of these "nuisance taxes" were introduced in the Dutch colonial period[19]. The Dris report recommends that all of these taxes should be carefully studied with a view to their modification or abolition[20].

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19 *Ibid.*, p. 509.

20 M. D. Dris, "Taxation in Indonesia", *Ekonomi dan Keuangan Indonesia*, Vol. XI, August-September 1958, p. 487-518.

TABLE IX

Major Components of Tax Revenue as Percentage of Total Tax Revenues, 1951-1959

Year	Tax on income & wealth[1]	Land tax	Customs duties: Total	Customs duties: Import duties	Customs duties: Export duties	Transaction & Consumption taxes[2]	Licences, stamp duties, registration fees, etc.	Other tax revenue
1951	15.8		27.2	14.1	13.1	55.4		1.6
1952	20.2		35.6	15.5	20.1	43.0		1.2
1953	23.8	.09	27.9	15.4	12.5	45.9	.7	1.6
1954	30.6	.10	19.6	12.6	7.0	47.1	1.1	1.4
1955	31.2	.08	18.8	11.2	7.6	47.7	1.0	1.2
1956	22.9	.08	16.7	13.6	3.1	58.7	.8	.8
1957	25.1	.08	14.4	12.3	2.1	57.9	1.1	1.4
1958	28.6	.08	13.2	11.8	1.4	54.6	1.1	2.4
1959	40.7	.09	16.7	14.2	2.4	38.6	1.1	2.8

Source: Data computed from United Nations, Economic Survey of Asia and the Far East, 1956, 1959, 1961, Tables of government revenues.

1. Tax on wealth includes: capital assets, urban real estate, vehicles, household, radio.
2. Transaction and consumption taxes include: excise duties, turnover taxes, sales taxes, entertainment duties, and foreign exchange levies (except for 1959)

Land tax, licences, stamp duties, registration fees also produce insignificant yields, amounted to only around 2 per cent of the total tax revenues.

In the years 1951 and 1952, a boom of world prices enabled Indonesia to obtain great tax revenue from foreign trade. The foreign exchange levies (classified under transaction and consumption taxes in Table IX) alone in 1951 has produced 40 per cent of total government revenue[21]. This is actually a system of general export taxation carried out by means of a multiple exchange rate policy[22]. Customs duties which were 27.2 per cent and 35.6 per cent in 1951 and 1952, raised the total tax from foreign trade to over three-fourths of total government tax revenue. In later years, revenue from export duties fell drastically, comprising only 7 per cent in 1954 and 2.4 per cent in 1959. The main factor

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21 United Nations, Economic Survey of Asia and the Far East, 1960, Bangkok, 1961, Table 35, p. 87.

22 In the multiple exchange rate policy of 1950 to 1952, exporters were given Rp. 7.60 for each U.S. $1.00 earned, while importers purchases U.S. dollars at the rate of Rp. 11.40= U.S. $1.00. In another multiple exchange rate system which was introduced in September 1956, import goods were classified into nine categories, with surcharges varying from 0 to 400 per cent. Goods which defined as most essential would be purchased at the official exchange rate (Rp. 11.4= U.S. $1.00) while other goods were to be purchased at progressively less favorable exchange rates varying from Rp. 14.25 per U.S. $1.00 up to Rp. 57.00 per U.S. $1.00.

behind this shift was the fall in world prices for Indonesia's major exports. Several new taxes on export were tried in more recent years, all rather ineffective, except for the export-certificate plan which was introduced in Mid-1957[23]. Import duties since 1952 were also enforced through the introduction of the import surcharge system[24]. However, despite a certain increase in revenues from foreign exchange levies, import and export duties together have gradually declined to 13.2 per cent in 1958.

Taxes on consumption in Indonesia consist mainly of excise taxes, turnover taxes, and sales taxes. The greatest share of revenues from consumption taxation - about two-thirds in the past few years - has been produced by excise taxation. The import surcharge system and the foreign-exchange certificates system, which have been so prominently used since 1952, added substantially to the burden of

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23 Under this export-certificate system, all foreign-exchange recipients (exporters) were given foreign exchange certificates in the amount of the official rupiah (Rp. 11.40=U.S. $1.00) of their foreign-exchange earnings. All foreign exchange surrendered was made subject to an exchange tax of 20 per cent. Importers (who possess import licenses) must purchase foreign exchange certificates on the free market as their source of foreign exchange.

24 Import surcharge system, as the name implies, refers to duties additional to a basic import rate structure. Surcharge were levied according to the classification of essential and luxury.

consumers. If import duties also fell primarily upon consumers, levies upon consumers ranged from 58 per cent to 72 per cent of the total tax revenues from 1951 to 1958. In 1959, the structure of tax revenues has shifted from transaction and consumption taxes to customs duties and the taxation of income and wealth.

Indonesia's tax on wealth and property, which includes several minor taxes, produced a very insignificant amount of revenues every year. Taxation on income and wealth, which only shared 15.8 per cent of total tax revenues in 1951, has become increasingly important and reached 40.7 per cent in 1959. Company tax is levied against the net profits of limited-liability companies, limited partnerships, cooperatives, mutual insurance companies, societies and foundations operating for private interest, and foreign corporations operating in Indonesia. Most of these business enterprises employ modern methods of business procedure and have adequate accounting records, the enforcement of taxes is generally effective. Since 1951, revenues from company tax rose each year until 1956, when they fell sharply[25]. In 1958, however, they tended to increase again. The company tax since 1951 has been collected at rates ranging from

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[25] Bank Indonesia, Report of the Bank Indonesia, 1954-1955 through 1958-1959.

40 per cent on net profits below Rp. 500,000 to 52.5 per cent of profits above Rp. 2,500,000[26]. The personal income tax is assessed against all personal income, including wages, income from single proprietorships, and dividends on stocks in limited-liability companies. With the exception of the wage tax which is collected from employees by withholding, the enforcement of the personal income tax is done by estimating the net income by rather haphazard methods. This is because the standards of literacy, bookkeeping, and record maintenance are generally low among most of these personal taxpayers. This problem inevitably resulted in laxity of personal income tax enforcement coupled with widespread evasion.

It should be pointed out that direct income taxation primarily fell upon the capital-intensive sector of the economy. The tax structure in this sector possesses a high degree of progressivity and is effective in reaching high company incomes and personal incomes produced by modern industrial enterprise and trade. On the other hand, the labor-intensive sector, which includes all the nonmarket economy, production of food crops for the market, smallholders' production of agricultural export crops, small-scale cottage industry, and various small trading activities,

26 M.D. Dris, "Taxation in Indonesia", Ekonomi dan Keuangan Indonesia, Vol. XI, Aug.-Sept, 1958, p. 472-473.

enjoys a much less direct income tax burden, because the enforcement of income tax in rural areas is rather ineffective. The upper income groups within the sector, comprising of landlords, traders, lenders, and merchant-employers, usually succeed in obscuring their real income, and are able to escape part of the taxation. Speculative incomes of some of the landlords and traders, who engaged speculation of real estates and commodities on a personal basis, have notoriously evaded the reach of direct income tax. Therefore, the imposition of capital gain taxation, and taxes on inventories may have stimulating effect upon the flow of private investment to more productive activities.

Since independence, the Central Government has been striving for greater centralization of fiscal responsibilities. This action has been hampered by the strong tendency to retain local autonomy which was fostered by the Dutch colonial policies of indirect rule in an effort to preserve order and security. Central Government efforts to tax the labor-intensive sector inevitably produced local friction and inconvenience. It seems that the raising of tax collection should involve greater local government responsibility.

Indeed, the success of domestic financing of economic development in Indonesia will depend in large measure upon taking full advantage of the resources that can be mobilized through local fiscal processes. Local financial operations in Indonesia were carried on at three levels of administration - desa (village), Kabupaten (district) and province. Legally, each level of local government was supervised by the level above it. Generally, local finance was responsible for the maintenance of some local capital facilities such as roads, bridges, public buildings, schools, and irrigation works which were supported in part by the local recruiting of labor services. Capital equipment and a substantial part of expenditures were ordinarily obtained from Central Government subsidies. Yet it was felt that dependence on Central Government subsidy would restrict local investment. Local authorities did not always agree that all local investment projects should receive both Central Government approval and financing. Faced with limited amounts of revenue, local authorities of district and provincial levels were forced to collect new sources which usually produced conflict with Central Government's tax devices.

Central Government's direct fiscal access to areas outside Djakarta was represented by Central Government fiscal offices. In practice, however, the government has found it necessary to rely on local officials to collect a part of its tax revenues. But due to lack of communication facilities and clearly differentiated responsibility, supervision of the collection of taxes was rather ineffective. Conflicts between the central and local government over the distribution of revenue sources has led to the legislation on central and local fiscal relationships in 1956. Unfortunately, no government has taken measures to implement this act.

Local governments in Indonesia have a history of a relatively high degree of fiscal autonomy involving responsibilities for local developmental activities. Effective developmental policy depends largely upon the avoidance of excessive central control over local fiscal functions. Taxes which would be more efficiently collected by local administrations should be transferred to local units. This process will not only increase revenue for local units but also will lighten the burden of Central Government subsidies for the support of local current investment functions and to increase the Government's capacity to finance its development program.

CHAPTER IV

THE ROLE OF FOREIGN SOURCES

1. The Need of Foreign Capital and the Capital Absorptive Capacity

Economic growth depends upon substantial increase in investment, and underdeveloped countries face a serious problem in providing the requisite domestic saving. The gap between the level of investment required and the present level of domestic saving is so wide that most underdeveloped countries find it difficult to provide sustained economic growth. Of the ten countries in Southeast Asia mentioned in Table X, only three countries show an average level of net domestic saving exceeding 10 per cent of gross national product during 1950-1959. In other countries of the region, rates of net domestic saving ranged from -1.2 per cent in South Korea to 9 per cent in Thailand. With the exception of the Federation of Malaya and Ceylon, foreign saving accounted for 1 to 2 per cent of gross national product in many countries of the region, and even up to 8 and 10 per cent in Taiwan and South Korea. Many other countries mentioned in Table XI show a similar situation.

It is clear that foreign financial resources are needed not only to bridge the financial gap, but also to

TABLE X

Level of Domestic and Foreign Saving in South-East Asia Countries, 1950-1959[a]

(percent of gross national product)

	Gross total saving[b]	Foreign saving	Gross domestic saving	Depre-ciation	Net domestic saving	Net total saving
Burma	19.5	0.1	19.4	5.8	13.6	13.7
Ceylon	12.1	-0.6	12.7	2.3	10.4	9.8
China: Taiwan	17.1	7.5	9.6	5.7	3.9	11.4
Federation of Malaya	11.8	-10.2	22.0	4.5	17.5	7.3
India	16.4	1.5	14.9	6.4	8.5	10.0
Indonesia	6.2	0.4	5.8	3.0	2.8	3.2
Korea, South	13.2	9.8	3.4	4.6	-1.2	8.6
Pakistan	7.8	1.8	6.0	3.5	2.5	4.3
Philippines	8.5	1.6	6.9	4.9	2.0	3.6
Thailand	16.1	1.8	14.3	5.0	9.3	11.1

Source: United Nations, Economic Survey of Asia and the Far East 1961, Bangkok, 1961, Table 2-1, p. 43.

a. The period begins with 1951 for Burma, China: Taiwan and Indonesia, 1952 for Thailand, 1953 for South Korea and 1955 for the Federation of Malaya, and ends with 1957 for mainland China and the Federation of Malaya.

b. Equals gross domestic capital formation.

TABLE XI

Level of Domestic and Foreign Saving in Selected Underdeveloped Countries
1950 - 1959

(Percentage of gross domestic product)

	Gross total saving	Foreign saving	Gross domestic saving	Depre- ciation	Net domestic saving	Net total saving
Jamaica	21	9	12	7	5	15
Cyprus	19	12	7	4	3	15
Spain	18	2	16	8	8	10
Brazil	16	1	15	5	10	11
Portugal	16	5	11	5	6	11
Turkey	14	2	12	4	8	10
Guatemala	12	2	10	4	6	8
Chile	10	2	8	7	1	3

Source: United Nations, World Economic Survey 1960, New York, 1961, Table 2-2, p. 61.

maintain balance in their transactions with the outside world. The post-war experience of many Asian countries has been a good example. The availability of foreign saving has made it possible for them to speed up the rate of domestic investment without the need for a matching reduction in domestic outlays on government current expenditure or private consumption. It has also gone a long way towards alleviating the balance of payments situation.

A developing economy generally will import much of the materials and equipment needed for economic development. Developmental investment in industries and agriculture, by government or private enterprises, will inevitably impose heavier burdens on the supplies of foreign exchange. But economic development does not necessarily give rise to a larger export capacity, it may merely expand the demand for imports. The increase of foreign exchange requirements may well lie beyond the foreign exchange earning capacity of all underdeveloped countries. Thus, even if a country has adequate domestic saving, it does not follow that it can finance the import costs of its investment programme; it may nevertheless face a foreign exchange problem.

It is true that the improvement of export trade will make it possible to import larger quantities of goods. But the problem is that the main exports of underdeveloped countries are largely primary products which usually are exposed to large fluctuations in their market prices. Consequently, the export-based capacity to import has been slower than the growth in imports which chiefly consist of capital goods and raw materials for capital goods and consumer goods. Countries such as Ceylon, China: Taiwan, the Federation of Malaya and the Philippines have taken extensive measures to raise their export capacity[1]. However, it is unlikely that most underdeveloped countries can be expected to raise their export earnings over the next few years, high enough to replace foreign resources.

Many underdeveloped countries, such as those South and Southeast Asia countries given in Table XII, have high foreign exchange requirements for financing development programmes. External financial resources tend to become more and more important to underdeveloped countries in sustaining a reasonable rate of investment and growth.

While emphasizing the role of foreign capital in financing economic development, in underdeveloped countries, we must not ignore the problem of capital absorptive capacity. Economic development cannot be achieved only by increasing supply of capital. There is nothing automatic about transforming financial resources into output-producing investments.

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[1] United Nations, Economic Survey of Asia and the Far East, 1961, Bangkok, 1962, p. 26.

TABLE XII

Foreign Exchange Requirement in Some South East Asia Countries

(Percentage of total development expenditure)

Country	Plan period	Sector	Percentage
Burma	1961-1962 - 1964-1965	public	49
Ceylon	1954-1955 - 1959-1960	public	31
	1968	public & private	59
China: Taiwan	1957-1960	public & private	29
India	1961-1962 - 1965-1966	public & private	19
Indonesia	1956-1960	public	38
	1961-1969	public	50a
Pakistan	1960-1961 - 1964-1965	public & private	34
Philippines	1957-1961	public	35
	1960-1962	public & private	42

Source: United Nations, "Economic Development and Planning in Asia and the Far East", Economic Bulletin for Asia and the Far East, Vol. XII, No. 3, Dec. 1961, p. 15.

a. National Planning Council, National Overall Development Plan 1961-1969, Djakarta, 1961, p. 21.

The absorptive capacity of capital rests mainly upon the availability of complementary factors with which capital can be utilized effectively. Generally, most underdeveloped countries have limited capital absorptive capacity which is mainly due to the relative shortage of entrepreneurs, deficiency of skilled personnel, and the lack of technology and adequate supply of materials. In fact, human resources of underdeveloped countries constitute an even bigger bottleneck than material resources. The rate of illiteracy is high. The technical competence and health conditions of labour are poor. Except in a few countries, such as Taiwan and HongKong, who have been favourably endowed with a migration of technicians and entrepreneurs from Mainland China, as well as from the community of overseas Chinese; and India who inherited a large well-trained civil service to take care of all public enterprises and administer aid, the supply of entrepreneurs remains deficient in relation to the requirements. As a result, the efficient use of domestic and foreign resources is limited. However, the availability of foreign assistance and inflow of capital, besides the adding of resources, may help to build up complementary factors, mainly human resources, for growth.

The above situation of underdeveloped countries appears to be the case of Indonesia. Foreign capital is necessary to complement the domestic financing of development in Indonesia, because the country has suffered from a serious shortage of foreign exchange. The financial burden which a development program of adequate magnitude imposes is also beyond the total savings capacity of the country. In Indonesia, as in other less developed countries, a large quantity of raw materials and capital equipment for industrial production must in the short run be obtained from abroad. The ratio of capital goods imports to gross investment, as indicated by the Indonesian Planning Bureau, averaged to 29 per cent for the years 1951-1955[2]. The Bureau has also projected the foreign exchange ~~costs~~ requirements for the Five Year Plan period at 37.5 per cent of investment[3]. The foreign exchange requirements of the current Eight Year Plan go even as high as one-half the total investment outlays.

Although the import component accomplished by the private sector may be somewhat lower than for the public sector, and import of consumer goods has been restricted by the government since 1952, there is a limit to which foreign exchange requirement can be reduced for such purposes. On the other hand, increased foreign exchange requires

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[2] National Planning Bureau, "A Study of the Indonesian Economic Development Scheme", Ekonomi dan Keuangan Indonesia, Vol. X, Sept. 1957, Table III, p. 622.

[3] Ibid., p. 616-617.

expansion of exports as well as development of import-replacing industries. It is doubtful that a significant amount of foreign exchange can be earned in the short run to meet requirements.

The problem of meeting investment requirements for development in Indonesia is intensified by the existing chronic inflation which has been stimulated by budgetary deficit. Constant government dissaving was partly responsible for the low level of domestic saving, as shown in Table XIII. Inflationary pressure could be reduced and domestic saving increased by cutting current government expenditure. Yet even until 1960, military expenditures did not show sign of decreasing, while other large current expenditures remained necessary to achieve economic stability, a pre-condition for development.

An estimate made by Dr. Eugene Grasberg[4] of the Massachusetts Institute of Technology in 1955 suggested that Indonesia needs a net total investment rate of Rp. 13.7 billion per year, approximately 13 per cent of the national income, in order to achieve a sustained growth. Even at the very modest investment rate at 6 per cent of national income as given by the Bureau for the Five Year Plan, financial requirement for such a plan will remain beyond the domestic

4 Eugene Grasberg, Indonesia's Investment Requirements, Cambridge, Mass., Center for International Studies, Mass. Institute of Technology, Sept. 1955, Table 6, p. 29.

TABLE XIII

Components of Gross Domestic Saving of Indonesia
1951-1959

(percentage of gross national product)

	Government revenue	Government expenditure	Government saving	Private saving	Gross domestic saving
Indonesia	13.4	15.2	-1.8	7.6	5.8

Source: United Nations, Economic Survey of Asia and the Far East, 1961, Table 2-10 and Table 2-11, p. 53-54.

saving capacity of the country, thus underlining the need for foreign capital in financing the development program. Recognizing this point, the National Planning Council in drafting the current Eight Year Plan has emphasized the importance of the inflow of foreign capital especially direct foreign investment.

Indonesia has also been hampered by the deficiency of effective entrepreneurship and technical skills. Although much effort has been made through the Benteng policy to encourage Indonesian entrepreneurship since sovereignty, little has been achieved. The departure of thousands of Dutch managers and technicians and the restriction on Chinese entrepreneurs resulted in a serious entrepreneurial bottleneck. Therefore, effective use of whatever funds mobilized for development may be frustrated if such a bottleneck is not promptly overcome. Inflow of foreign technical aid and foreign capital coupled with managerial and technical skills would likely increase the capability of absorbing into productive use the capital required for development.

2. Foreign Aid

The bulk of external financial resources available to underdeveloped countries has been in the form of public funds. For example, the components of foreign savings of some Asian countries, as shown in Table XIV, indicate the

TABLE XIV

Foreign Saving and Its Components in Selected Asian Countries 1950-1959[a]

Country[b]	Total Foreign saving (per cent of gross national product)	Per cent of total foreign saving: Net inflow of remittances and donations — Private	Net inflow of remittances and donations — Official	Net inflow of long term capital[c] — Private	Net inflow of long term capital[c] — Official	Short term capital & gold movements	Errors and Omissions
Korea, South	9.8	6	97	-	-	-3	-
China: Taiwan	7.5	4	67	10	13	7	-1
Pakistan	1.8	-3	59	1	15	30	-2
Thailand	1.8	-14	65	10	18	-26	47
Philippines	1.6	14	59	51	10	9	-43
India	1.4	20	12	-3	27	55	-11
Indonesia	0.4	1	97	-7	-5	43	-29
Burma	0.1	-172	344	-	-70	31	-33
Ceylon	-0.6	-238	68	-78	29	86	33

Source: United Nations, Economic Survey of Asia and the Far East, 1961, Table 2-5, p. 48.

a. The period begins with 1951 for Burma, China: Taiwan and Indonesia, 1952 for Thailand and 1953 for South Korea.
b. Ranked in the decending order of the percentage rate of foreign saving to national product.
c. Including loans, investment and reparations payments.

greater share for official capital assistance. This foreign assistance has been extended either bilaterally through inter-governmental arrangements, or multilaterally through international agencies, in the form of grants or loans. In addition to the complex picture of various sources and forms of external assistance, there have been marked disparities of aid received per capita among receiving countries. Furthermore, the efficiency of foreign aid in promoting economic development is not necessary in proportion to the amount received by the recipient countries. Political and economic stability, the contents of the aid programme, and the absorptive capacity of the country concerned appear to be the influencing factors in this regard.

So far, the greater part of economic assistance to underdeveloped countries has been provided bilaterally on a givernment-to-government basis. Such assistance is usually linked with political and strategic considerations rather than strict long-term economic requirement. Bilateral contributions, either in grants or in loans, quite often are tied with certain specific projects which are conspicuous. Although it may not be possible to integrate such projects with national development plans, the domestic resources released can be used for other purposes. Bilateral assistance is sometimes also tied to the giving of some specific commodities, such as food, other consumer goods, raw materials or capital goods. The American surplus commodity disposal program is a good example. Commodities sold for local currency was assigned to financing development projects. To those countries who import a great quantity of foodstuffs, such aid will enable them to devote foreign exchange and real resources to other uses. Objections do sometimes arise, however, from other exporters of the same products, in that surplus disposal will adversely affect their market prices. In solving this problem, it is believed to be desirable that surplus commodity disposal be handled by international agreements involving both recipient countries and all major exporters of the surplus items.[5]

Of all the participating countries in bilateral capital assistance to underdeveloped countries, United States has provided the biggest part and is likely to remain the principal source. Through a series of government agencies, total economic assistance including grants and loans from the United States reached $61.5 billion from the year 1946 to 1961.[6] Other grants and loans for military purposes amounted to 29 billion for the same period. Although a

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[5] B. Higgins, Economic Development, N.Y., W.W. Norton & Company Inc., 1959, p. 625.

[6] United States, U.S. Foreign Assistance and Assistance from International Organizations, Agency for International Development, Statistics and Reports Division, March 1962, Table, p. 1.

bigger amount of $28 billion of this total economic assistance went to Europe, its annual share has been substantially reduced, while other regions of the world who occupied a lesser total amount during the period, have greatly increased their share in more recent years. This is because aid is most needed in many underdeveloped countries in these areas.

United States' authorized foreign aid in 1961 amounted to $5.98 billion of which $1.43 billion was for military aid. Economic assistance in 1961 increased by $1.14 billion over 1960, but military assistance dropped by $729 million[7]. Among agencies making aid for development, the International Cooperation Administration and the Export and Import Bank have operated on the biggest scale, approximately half of the total amount in 1961. The Development Loan Fund and the surplus commodity disposal program have also become an increasingly important form of aid from the United States.

Other countries such as Australia, Canada, United Kingdom, New Zealand, France, West Germany, Japan and many others have also provided useful amounts of capital and technical assistance to less-developed countries. The Sino-Soviet Bloc also provided aid to her allies and some Asian uncommitted neutralist countries. But the amount of aid was

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[7] U.S., U.S. Foreign Assistance, Op. Cit., Table, p. 1.

much smaller than that of the United States. Available figures from 1954 to 1959 show a total of 2.5 billion[8].

Multilateral contributions extended by international agencies include the following: International Bank for Reconstruction and Development, International Finance Corporation, International Development Association, Inter-American Development Bank, United Nation Technical Assistance, United Nations Special Fund, and the European Development Fund of the European Economic Community. The amount of assistance given by these organizations throughout the years 1947 to 1961 and its regional distributions are shown in Table XV and Table XVI.

While the total inflow of foreign economic aid to underdeveloped countries has recorded a marked increase of about 63 per cent between 1953-1954 - 1955-1956 and 1957-1958 1958-1959, as given in Table XVII, a change in its composition has also occurred. The trend has been increasingly towards loans rather than grants as a means of aid. Table XVIII shows that the share of loans in total public aid rose from 27 per cent in 1953-1954 - 1954-1955 to 37 per cent in 1957-1958 - 1958-1959, but the share of grants declined by 10 per cent. Economic aid from United States has the same

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[8] United Nations, International Economic Assistance to the Less Developed Countries, Dept. of Economic and Social Affairs, New York, 1961, Table 36, p. 51.

TABLE XV

Assistance from International Organizations
1947-1961

(millions of dollars)

	U. S. Fiscal Year											
	1947-1950	1951	1952	1953	1954	1955	1956	1957	1958	1959	1960	1961	Total
World Wide Total	786.1	287.3	275.0	186.6	337.1	423.5	422.2	420.5	728.5	765.8	820.4	1036.5	6489.2
IBRD (International Bank for Reconstruction & Development)	786.1	287.3	270.2	167.4	319.2	403.0	395.3	387.5	686.2	689.2	658.7	609.8	5668.8
IFC (International Finance Corporation)								1.0	8.5	10.0	18.9	6.2	44.4
IDA (International Development Association)												101.0	101.0
IDB (Inter-American Development Bank)												70.0	70.0
UNTA (UN Tech. Assist.Program)			4.8	19.2	17.9	20.5	26.9	32.0	33.8	41.2	40.0	43.4	279.7
UNSF(UN Special Fund)										8.2	46.5	70.9	125.6
EEC (European Ec. Community Dev.Fund)										8.2	56.3	135.2	199.7

Source: United States, U.S. Foreign Assistance and Assistance from International organizations. Agency for Intern. Development. Statistics and Reports Divisions, March 1962.

TABLE XVI

Assistance from International Organizations - Regional Distributions, 1947-1961
(millions of dollars)

	1947-1950	1951	1952	1953	1954	1955	1956	1957	1958	1959	1960	1961	Total
Europe	549.6	[illegible]2.5	66.1	35.9	37.5	148.2	41.0	121.5	98.9	106.1	73.6	60.4	1,341.2
Far East	-	25.4	1.0	3.1	40.5	3.4	48.8	32.8	165.8	143.0	104.6	165.6	734.0
Near East and South Asia	63.0	25.1	55.1	47.4	33.6	61.4	131.2	123.4	224.5	234.3	223.5	334.5	1,557.0
Latin America	173.5	75.8	54.0	34.6	102.1	129.7	82.9	60.4	122.4	156.3	169.1	286.4	1,447.2
Africa	-	8.5	98.4	15.3	8.7	25.8	92.3	22.4	90.8	87.8	245.6	187.9	883.5
Australia	-	100.0	-	50.0	54.0	54.5	-	59.2	0.7	0.2	0.1	-	318.7
South Africa	-	50.0	-	-	60.0	-	25.2	-	25.0	36.6	-	-	196.8
Non-regional	-	-	0.3	0.3	0.7	0.5	0.8	0.8	0.4	1.5	4.1	1.4	10.8
TOTAL													6,489.2

Source: United States U.S. Foreign Assistance and Assistance from International Organization, Agency for International Development, Statistics and Reports Divisions, March 1962, p. 119-130.

TABLE XVII

Expansion in Public Economic Assistance
to Underdeveloped Areas
1953/54-1955/56 to 1957/58-1958/59

(1953/54-1955/56, Average = 100)

Region	Index, 1957/58-1958/59, Average		
	Grants	Net Loans	Total
Latin America	202	265	244
Africa	157	84	121
Asia	133	595	168
Oceenia	179	-	179
TOTAL -	142	218	163

Source: United Nations, International Economic Assistance to the Less Developed Countries, Department of Economic and Social Affairs, New York, 1961, Table 24, p. 43.

TABLE XVIII

Share of Grants and Loans in Public Economic Assistance to Under-developed Areas 1953/54-1955/56 and 1957/58-1958/59 (percentage)

Region	1953/54-1955/56		1957/58-1958/59	
	Grants	Net Loans	Grants	Net Loans
Latin America	33.1	66.9	27.3	72.7
Africa	50.7	49.3	65.9	34.1
Asia	92.3	7.7	72.9	27.1
Oceania	100.0	-	100.0	-
TOTAL	72.7	27.3	63.4	36.6

Source: United Nations, International Economic Assistance to the Less Developed Countries, Department of Economic and Social Affairs, New York, 1961, Table 25, p. 44.

tendency. This shift does not necessarily imply a great increase of debt servicing capacity of the recipient countries, but has been "in conformity with the policy of a number of recipient countries which have expressed, as a matter of general policy, preference for economic aid in the form of loans"[9]. However, the greater amount of foreign aid is still in the form of grants.

Countries which are typically concerned for national pride and wish to maintain a sense of complete independence may prefer loans to grants, which they expect, of course, to be at low rates of interest and with easy terms of repayment. Loans would naturally be more acceptable to the donor countries. But still many other recipient countries, such as most countries in Asia, who are concerned mostly with their urgent needs and the heavy burden of servicing debts, stress the aid of grants. Today, Asian countries as a whole still absorb the biggest share of total grants, although on a decreasing tendency.

Foreign assistance has been of vital importance to underdeveloped countries. It has contributed not only to the substantial relief of the burden of military commitments of many countries, but also has provided the crucial margin

[9] U.N., International Economic Assistance to the Less Developed Countries, Op.Cit., p. 43.

required to tide over the balance of payments difficulties. For example, while average export earnings of these countries, over the period of 1953-1954 - 1954-1955 to 1957-1958 - 1958-1959, increased by only about 5 per cent, foreign aid received rose sharply by 75 per cent, as indicated in Table XIX. The ratio of economic aid as percentage of export earnings in Asian countries rose from 11 per cent to 19 per cent in the same period. Foreign aid has alleviated food crises in such countries as India, made possible productive investments in Thailand and the Philippines, assisted specific projects such as steel mills in India, dams in Taiwan and Thailand, and more general services such as agricultural extension or building up pre-investment conditions. As a result, it helps either the momentum of growth without more reduction in consumption, or the maintenance if not the rising of the levels of living of many countries.

While recognizing the great quantity of foreign aid and the important role which it has already played upon many underdeveloped countries, the case of Indonesia does not suggest entirely the same situation. Looking at Table XX we notice that the annual average total foreign assistance per capita in Indonesia during the period of 1950-1959 is the second lowest in countries.of Asia. Again in Table XXI Indonesia appears to be the only country that has incurred an increase in government deficits between 1950-1952 and

TABLE XIX

Expansion in Public Economic Assistance and in Export Earnings

1953/54-1955/56 to 1957/58-1958/59

Region	Index, 1957/58-1958/59, average: Public economic assistance	Index, 1957/58-1958/59, average: Export earnings	Public economic assistance as percentage of export earnings: 1953/54-1955/56	Public economic assistance as percentage of export earnings: 1957/58-1958/59
	(1953/54-1955/56, average = 100)			
Latin America	248	104	2	6
Africa	128	104	14	18
Asia	185	107	11	19
TOTAL	175	105	8	13

Source: United Nations, International Economic Assistance to the Less Developed Countries, Department of Economic and Social Affairs, New York, 1961, Table 28, p. 45.

TABLE XX

Economic Assistance Received by Asian Countries 1950-1959[a]

(annual average in dollars)

Country[b]	Assistance received per capita		
	Official[c]	Private[d]	Total[e]
Laos[f]	23.30	-	23.30
South Viet-Nam[f]	19.19	-	19.19
Korea, South	9.78	0.26	10.04
China: Taiwan	8.29	0.27	8.56
Cambodia[f]	7.68	-	7.68
Iran	2.94	-	2.94
Philippines	2.22	0.43	2.65
Thailand	1.46	-0.20	1.26
Pakistan	1.03	-0.03	1.00
Afghanistan	1.00	-	1.00
India	0.41	0.19	0.60
Indonesia	0.36	-0.05	0.31
Nepal	0.30	-	0.30
Burma	0.45	-0.39	0.06
Ceylon	1.55	-1.63	-0.08

Source: United Nations, Economic Survey of Asia and the Far East, 1961, Table 2-6, p. 49.

a. The period begins with 1951 for Iran, 1952 for Nepal, Pakistan and Thailand, and covers 1953/54 to 1958/59 for Ceylon and United States fiscal years 1955 to 1959 for Cambodia, Laos and South Viet-Nam.
b. Countries are ranked in the descending order of the size of per capita total assistance.
c. Including official loans and donations.
d. Including private remittances and donations but excluding private loan inflow.
e. Official assistance only, where private assistance is not known.
f. Economic assistance only from the United States.

TABLE XXI

Government Investment, Saving and Deficits and Foreign Saving in Selected Asian Countries, 1950-1952 and 1957-1959

(per cent of gross national product)

Country	Government[a]						Foreign saving	
	Gross investment[b]		Gross saving		Budget deficit[c]			
	1950-1952[d]	1957-1959	1950-1952[d]	1957-1959	1950-1952[d]	1957-1959	1950-1952[d]	1957-1959
Burma	6.7	9.7	5.0	1.3	1.7	8.4	-7.0	4.0
Ceylon	6.7	7.8	3.4	2.6	3.3	5.2	-0.2	2.8
China: Taiwan	8.6	12.2	1.0	0.3	7.6	11.9	4.9	7.7
India	3.1	12.3	1.6	1.1	1.5	11.2	0.3	3.0
Indonesia	1.8	1.8	0.5	-4.1	1.3	5.9	0.3	0.3
Korea, South	4.2	9.0	-3.5	-3.4	7.7	12.4	6.6	8.8
Pakistan	4.7	5.8	3.1	0.1	1.6	5.7	0.7	3.1
Philippines	3.0	2.3	1.1	1.7	1.9	0.6	0.7	1.9
Thailand	4.7	4.3	-0.1	1.2	4.8	3.1	2.1	2.9

Source: United Nations, Economic Survey of Asia and the Far East, 1961, Table 2-14, p. 59.

a. Including government enterprises.
b. Including capital transfers to the private sector and inventory changes.
c. Excess of gross investment over gross saving.
d. 1951-1952 for Taiwan and Indonesia, 1952-1953 for Thailand, and 1953-1954 for South Korea.

1957-1959 but has not increased foreign saving.

The low level of foreign aid in Indonesia as compared with other underdeveloped countries need not be explained in terms of per capita income levels or economic absorptive capacity of the countries concerned. South Korea, whose income per capita is about the same as Indonesia, received ten times as much economic assistance between 1957-1959[10]. And Laos, which is still in a very backward state with a low absorptive capacity, received the greatest amount of foreign economic assistance among Asian countries. Probably the general political and economic consideration of both the donor countries or agencies and Indonesia is a dominating factor. Nevertheless, no matter how small the aid was, one can not deny its contribution to the Indonesian economy, especially in the provision of technique and management which have served as a stimulus to growth.

Foreign bilateral and multilateral economic assistance to Indonesia between July 1957 and June 1959 totalled $229.1 million, of which $3.8 million was grants from United Nations agencies (see Table XXII). This total amount also included a special grant of $176.9 million from Japan in 1958 as war reparation which greatly strengthened the balance of payment situation of that year. Therefore, the actual amount of foreign aid received per year is only about $24.2

10 Ibid., Table 27, p. 45.

TABLE XXII

International Economic Assistance to Indonesia
July 1957 - June 1959

(million of dollars)

Contributing country or agency	Grants	Loans
Bilateral Aid:		
Australia	1.7	-
Canada	0.4	-
Japan	176.9	-
New Zealand	0.4	-
United Kingdom	-	-
United States	21.0	19.4
Yugoslavia	-	5.5
	200.4	24.9
Multilateral Aid:		
IBRD (International Bank for Reconstruction and Development)	-	-
UNICEF (United Nations Children's Fund)	1.3	-
UNTA (United Nations Technical Assistance	2.5	-
	3.8	

Source: United Nations, International Economic Assistance to the Less Developed Countries, Department of Economic and Social Affairs, New York, 1961, Table 1, p. 12.

million. In Indonesia, as in many other underdeveloped countries, the greater amount of aid received is in the form of grants, and United States is the biggest aid contributor. Other contributions come from the Columbo Plan donating countries, and from the USSR, East Germany, and Czechoslovakia whose amounts are not available.

In view of the need of economic development, the balance of payment difficulties, and the continuing budget deficit which should be partly offset by imports financed by foreign aid, the amount of foreign aid, especially from the United States, must be increased. Benjamin Higgins once argued that Indonesia has the absorptive capacity to use effectively at least $100 million U.S. aid per year[11]. A substantial part of this aid could be in the form of surplus commodities whose imports would conserve foreign exchange against short-run balance of payments fluctuations. Other injections of consumer goods would offset the existing inflationary pressures. In addition, aid in the forms of technical and managerial knowledge, and complementary development goods would increase productivity and assist in restoring domestic production.

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11 Benjamin and Jean Higgins, "Indonesia: Now or Never", Foreign Affairs, Oct. 1958, p. 6.

3. Foreign Investment

Apart from foreign capital in the form of loans and grants, other foreign financial sources which can be used to help economic development of underdeveloped countries are private foreign investment. However, it is quite difficult for underdeveloped countries to attract large amounts of foreign private capital especially at their early stage of development. For example, the flow of private foreign capital to Asia and the Far East was "exceedingly low during the early post-war years, owing chiefly to changes in the political situation and uncertainty regarding the economic policies of some newly independent countries on the one hand, and to the need for economic rehabilitation, the cautious attitude of private investors and the other opportunities open to private investors in the capital-exporting countries on the other"[12].

A study issued by the Department of Economic and Social Affairs of the United Nations also pointed out that most of the international flow of private capital during 1956-1958 has taken place between the more-developed countries, while the poorer countries where needs remain particularly great received a comparatively small share of foreign

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12 United Nations, "Economic Development and Planning in Asia and the Far East", Economic Bulletin for Asia and the Far East, Vol. VII, No. 3, Nov. 1956, p. 59.

private capital[13]. The total gross amount in recent years has been estimated by the United Nations as about 2 billion dollars a year during 1955-1958[14]. If the profits re-invested by foreign enterprises were included, the total may rise to 2 1/2 or 3 billion dollars a year.

Generally, private foreign investment in under-developed countries went chiefly to the export industries producing primary goods that could serve as raw materials for manufacturing industries in advanced countries. Thus, the region most favoured by private foreign investors has been Latin America which has been receiving over a billion dollars a year. In the period of 1956 to 1958, nearly 35 per cent of the world total of private foreign capital went to the countries which were exporters of petroleum[15]. In the region of Asia and the Far East, the inflow of long-term private during 1950 to 1959, as appeared in Table XIV, is much less significant than the inflow of public donations except Philippines. This low inflow of foreign private capital is either because such profit opportunities do not exist or because entry is restricted by government rules and

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[13] United Nations, International Flow of Private Capital 1956-1958, New York, 1959, p. 11.

[14] United Nations, International Flow of Private Capital, p. 9.

[15] United Nations, International Economic Assistance to the Less Developed Countries, p. 46.

regulations. In India, for example, oil exploration, extraction, refining and even distribution, and other mining have been increasingly assigned to or reserved for the public sector, the entry of private capital or expansion of existing plant is therefore discouraged.

Foreign private investors usually prefer more-developed countries for long-term investment because they feel that their capital is more secure, returns are higher, and their enterprises will be allowed more freedom than in most underdeveloped countries. Indeed, there are many obstacles which retard foreign investors from investing a greater amount of capital in underdeveloped countries. The inadequate and uncertain rates of returns, the limitation of profit transference, foreign exchange control, taxation, labour problems, and above all, the threat of expropriation and nationalization are the major impediments to higher foreign investment.

Public utilities such as transportation, irrigation, power, and communications are generally not very attractive to foreign private investors. Fields which seem profitable to them are traditionally limited to oil, other mining and estate crops mainly for export. Since the war, political independence of many countries has been followed by a policy of nationalization and strict control over certain key industries. Nationalist revolutions and the emergence from colonialism have left an aftermath of suspicion of foreign enterprises. Furthermore, the general internal political and economic instability coupled with the lack of trained labour in many of the underdeveloped countries have also given rise to the hesitation of foreigners to invest.

Although many governments in underdeveloped countries have clarified their policies toward nationalization of private industries in recent years, and have made guarantees by special legislation or by a policy statement for foreign investment, the inflow of foreign investment has not been very promising. The attraction of foreign investment requires a combination of many favourable factors. Unless the overall condition can be improved, the prospects of a greater flow of private foreign capital into these countries appear to be undertain.

Concerning the role of foreign investment, there is little doubt about the important contribution which it made to the economic growth of underdeveloped countries. This is especially true of foreign direct investment. Many of the exchange-earning industries of underdeveloped countries have been built up and developed chiefly by foreign direct investment. For example, the oil industries of the Middle East and Venezuela; the rubber plantations and tin mining of Malaya and Indonesia; the tea estates of India and Ceylon; and the sugar estates of Cuba and West Indies have provided the countries with very substantial incomes.

Foreign sources in the form of investment, unlike foreign loans, do not leave an aftermath of interest charges and repayment. Although the use of loans can be directed by the government into fields of priority, unless such investments are efficiently managed and could be expected to yield reasonable outcome, the future paying of debt will increase the country's burden of indebtedness. Foreign direct investment is dictated more by commercial rather than political consideration, and tends to provide some safeguard against the misuse of available capital. It has other advantages in that it usually introduces new industries, new techniques, and improved methods. As a result of more investment, more employment and technical training opportunities will become available. It also contributes to the government's revenue by paying income tax and export duties.

Since the need of foreign financial sources is indispensable for economic development, and the inflow of foreign private investment has its great advantage, measures should be taken to encourage its continuity and increase its inflow without at the same time sacrificing the country's sovereignty or losing freedom with respect to economic policy. In fact, the stage of colonialism is passed; many underdeveloped countries should take a new attitude toward foreign investment. A foreign enterprise operated under a sovereign country which has its own law, tax and monetary legislation, exchange control, is not much different from an enterprise handled by its nationals.

Nothing could be more important than the giving of confidence to foreign investors. Their fears of the assets being confiscated or nationalized without fair compensation, of the discriminatory taxation imposed on them, and of the restriction of repatriation, should be removed by more effective official arrangements and guarantees. Foreign investors' primary aim is for profit expedition, they would be attracted by the discovery of new investment opportunities which would usually be revealed by fuller investigation and research. Other device could be the "joint ventures" of the government and foreign enterprises to assure reasonable profits for both participants.

Foreign investment had been of great importance to Indonesia's economic growth during the colonial period. It started early in agricultural enterprise and trade, and later extended to mining and other activities. The Dutch investment predominated at about two-thirds of the total investment[16], and left a rather insignificant share to other investors. American investment began to increase only after 1920's mainly moving into the production of oil and rubber.

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16 U.S. Dept. of Commerce, Investment in Indonesia, U.S. Government Printing Office, Washington 25, D.C., 1956, p. 10-11.

No accurate estimates of foreign investment in both the pre-war and the post-war period are available. It is generally recognized that the value of foreign investment has been substantially reduced during the post-war years. Except the petroleum operations, many foreign companies have only been able to rehabilitate their former holdings; expansions of their existing plants were merely negligible. Many Dutch firms have tried to repatriate their earnings and capital. British investment may also have decreased, and American investments have been small. As indicated by a United Nations report in Table XIV, there has been a net outflow of long-term capital from Indonesia during the period from 1950 to 1959.

Having emerged from the colonial status many Indonesians will inevitably regard foreign investment as exploitation. Yet it must be conceded that without the inflow of Dutch and other foreign capital the growth of the Indonesian economy would have been slower. Indonesia is no exception in the respect of enjoying some advantageswhich foreign investment generated upon the economy. The important export industries such as petroleum and rubber, which provide the country with nearly all the amount of foreign exchange earnings, were first developed by foreign capital.

During the past half century, resource discovery and the resulting opening of new frontiers have been associated chiefly with foreign plantations and mining companies. The continuous search for new oilfields in unsettled jungle by the foreign oil companies for example, has contributed not only to the increase of resources but also to the development of new areas. A report published by the U.S. National Planning Association regarding a case study of the American Standard Vacuum Oil Company in Indonesia[17], indicated that this company alone during its operation has contributed in the construction of over 775 miles of roads, two airfields, one ferry service, and some 125 miles of telephone which have all been placed at the disposal of government departments or the public. In addition to the contribution of transportation and communication facilities, the company has contributed other social capital such as the building of houses and schools. As a result, people were attracted to move in the previously unsettled areas, and the smallholders' agricultural operations were being facilitated to expans. Foreign enterprise in Indonesia may have also contributed to the growth of technological progress and entrepreneuship by using the latest and most efficient techniques and by providing incentives, opportunities, and training for indigenous entrepreneurs.

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17 M.I.T. Indonesia Project, Stanvac in Indonesia, Washington, D.C., National Planning Association, 1957, p. 63-65.

The role of foreign financing has been emphasized by the government in the current Eight Year Plan, but opted in favor of foreign direct investments rather than foreign loans. It was expected that foreign capital would be attracted to exploit oil, rubber, copra, timber, tin, and fisheries. The government also firmly stated that all foreign investment would be accepted on the principle of fair sharing and partnership in projects or undertakings[18].

The important problem remains of how to attract substantial direct foreign investment to a country which is saturated with anti-imperialist propaganda, and where the nationalists still have deep conflict with the realists. Although in recent years, more Indonesians have recognized that a more tolerant policy in relation to foreign capital is fundamental to Indonesia's future economic development, the general climate for foreign investment is still not very promising as a result of continuous political and economic instability. The bright prospect of the inflow of foreign private capital has yet to be achieved by both the people and the government of Indonesia.

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[18] National Planning Council, National Overall Development Plan 1961-1969, Djakarta, 1961, p. 24. The government expected to achieve the exploitation of the country's unused natural resources in partnership with foreign enterprises. Profits from these investments will be divided on a 50-50 basis between the Indonesian government and the foreign investors.

CONCLUSIONS

The foregoing discussions of the task of searching financial resources for economic development in underdeveloped countries show that it is a rather complex and difficult problem which does not have a straight answer and can not be solved independently and in a very short time.

The deficiency of the mobilization of private voluntary savings for industrial and productive investments is a common characteristic of most underdeveloped countries. This failure stems not only from the general low level of income but also from the inefficient financial institutions and the general instability and insecurity of political and economic environment. However, an overall well-organized financial system must not be less stressed, for without proper control and supervision, as in Indonesia, the burgeoning of such institutions would only lead to some adverse effects.

The use of budget deficit as a means of financing development has its self-defeating effect. The post-war experience of many Asian countries, Indonesia in particular, has shown that such deficit finance is a great contributing factor to inflationary pressures which are detrimental to growth. The aim of deficit financing in transferring real resources from the private sector to the government's disposal may be frustrated by the rigidity or the increase of effective demand of the private sector. Unless there is idle capacity and a reserve of trained personnel, it is unlikely that government expenditure will immediately increase production which can be used to meet the increasing aggregate demand. Furthermore, the second purpose of utilizing the reservoir of under-employed man-power is limited by the lack of complementary factors for its efficient use. Therefore, it is believed to be undesirable for underdeveloped countries to rely upon deficit financing. The government should pay increasing attention to the more fundamental and inevitable task of augmenting government saving through economizing in non-development expenditure and by tax reform.

In underdeveloped countries where the role of government investment has increasingly become important in the venture of economic development, compulsory transfer of financial resources through taxation is a more effective and essential means of achieving the goal. A sound tax policy may not only increase government saving but also may positively influence the rate of private saving. The tax system of many underdeveloped countries has much to be improved. Tax revenue can be raised by a strengthening of the assessment on commodities and on the domestic income and wealth, and of the efficiency of collection machinery to avoid tax evasion.

CONCLUSIONS

Although much effort has been made, the increase of domestic saving in some countries has been modest; and in many other countries domestic saving has declined. The financial requirement for a satisfactory and sustained rate of economic development is beyond the unaided power of most underdeveloped countries. The inflow of foreign sources has been, and will continue to remain, of crucial importance to these countries. The trend of greater foreign private investment concentrated in comparatively higher income and exporting countries, and more official assistance of grants and loans to lower income countries, is not likely to change in the near future. Concerning the weak power of debt servicing in some of these countries, grants in the form of financing imports and supplying technical assistance should be preferred. Foreign private capital which has many advantages to the countries' development should also be effectively attracted by providing adequate incentives. However, being influenced by many factors, receiving countries cannot count upon the inflow of foreign savings to step up their rates of growth; strenuous domestic efforts are of basic importance. A combination of both domestic and foreign resources, together with the improvement of human resources to assure their efficient use, should much improve the prospect of achieving faster economic development.

Among underdeveloped countries, Indonesia belongs to the lower group, and is confronted with most of the serious problems in financing economic development. Typical institutional factors and inefficient mobilizing machinery have resulted in a low level of private voluntary savings. Great military outlays and other current expenditures matched by inadequate government revenue have caused government dissaving. The failure to obtain a large quantity of foreign sources to offset the low level of domestic saving has restrained the country from substantially increasing investments during the last decade.

On the other hand, the government's constant increase in budget deficit financed mostly by borrowing from the central bank has led to chronic inflation, which tends to distort investment in favour of speculative enterprises. The importation of necessary goods has aggravated the balance of payments difficulties. Thus, economic and financial crises coupled with unsettled political instability have generated further strain on the available resources and resulted in economic stagnation. A reduction of government non-essential expenditure and some sacrifices of the people's consumption are necessary for realizing a higher rate of real domestic saving. But the great task of eliminating government deficit, rebuilding foreign exchange reserves, and financing developmental investment requires the supplement of a substantial inflow of foreign funds. Therefore, every effort should also be made to assure a favourable climate for attracting foreign aid and investment. Finally, an endeavour embodying the building up of an efficient and co-ordinating human factor would represent a sound approach to Indonesia's economic development.

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