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STRUCTURAL ADJUSTMENT POLICIES AND THEIR IMPLICATIONS FOR THE INDONESIAN ECONOMY

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under my supervision. The relevant comments made on the Paper during its presentation have been incorporated in the present version of the paper to my full satisfaction.

I have pleasure in recommending that the graduate committee may approve the paper in partial fulfilment of the requirements for the degree of Master of Economics.

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ABSTRACT

Since 1969, Indonesia put more emphasis on econommic development after nearly three decades in continuous political crises. When political sistem was stabilized economic programmes were given more priority to progress. Efforts to develop the economy then coincided with the oil boom in 1974, as a result of prices increases in world market, which add substantial revenue for the government's expenditure.

In 1983 the oil prices in the world market decreased drastically, bringing a set back to the revenue. The government responded by restructuring the budget expenditure, and at the same time setting economic reforms including liberalization, privatization and deregulation policies.

This paper is basically to see the effects of the adjustment policies and reforms on selected areas in Indonesian economy. The paper consists of six parts. Part I, II, and III discuss on Indonesian economic background and rationales of adjustment policies by the government. Part IV highlights the policy reforms taken by the government when she expected the oil prices would no more increase. Part V discusses the implications of adjustment policies and the reforms in selected areas. The choice of the areas is based on development perspective. Part V is the conluding remark which is followed by appendix to Part III, on chronology of adjustment policies and reforms. The last section is the list of references on which this paper is based on.

I. INTRODUCTION

After 23 years of independence, Indonesia started putting renewed emphasis on her economic development. This decision was taken after a long and turbulent political life as a result of multi-party system, which tended to lead Indonesia towards anarchy. Such view is held by "New Order" government[1], the ruling government, that aimed at successfully stabilizing the political life. This stabilisation is assumed as a necessary condition to pave the way for a successful economic development.

Having focused on economic development, Indonesia put more attention on domestic and international economic environment which might have major influences on its development. Therefore policies and measures were taken to respond to the situations since the beginning of 1970, two years after the New Order government took power.

. To materialize the desired national objectives, the government also started implementing five-year plans (Rencana Pembangunan Lima Tahun - Repelita). During the first and second five year plans, the economy has been geared to a fast pace due to oil endowment. High revenue

1 "New Order" refers to Soeharto's military-backed ruling government elite. They took power after the failure of an abortive coup by Indonesian Communist Party (PKI) to topple President Soekarno in October 1965. The other term, "Old Order" is referred to Soekarno's era/clique/thought/way in Indonesian political system before the coup.- See Donald Wilhelm, Emerging Indonesia (London: Cassel, 1986). Also, Donald K. Emerson, Indonesia's Elite : Political Culture and Cultural Politics (New York: Cornell University Press, 1976).

from oil was channelled through social welfare programmes and long-run projects as well.

However, the importance of the oil boom which was the main source of revenue for the government to sustain the development efforts has been reduced due to the uncertainty in the world price. While maintaining the expenditure, an alternative source to replace the oil is to enhance non-oil production. However, with quality constraints and lack of efficiency this policy could not help much. The government then devalued the currency to make the commodity cheaper in the world market.[2]

Deregulation is another policy taken by the government in anticipation of the economic slow-down resulting from the oil shock. Regardless of its trend in global perspective, the government seemed to have little choice other than to lessen her regulation to enhance economic activity in domestic market. Starting in December 1983, the first and primary target of deregulation was financial area, which is intended to make the financial system more competitive and enhance Bank Indonesia's (the Central Bank) effectiveness. These steps were designed to enable the financial system to contribute to the attainment of broader economic goals, notably the further diversification of the economy and the expansion of non oil exports.[3]

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2 See David C.Cole and Betty F. Slade, "Financial Development in Indonesia," in Anna Booth, ed. The Oil Boom and After, (Singapore: Oxford University Press, 1992), p.77

3 Binhadi and Paul Meek, "Implementing Monetary Policy," The Oil Boom and After p.112

Other financial deregulation packages were launched in 1988 and 1989, and were known as Pakto (Paket Oktober - October Package), PakDes (Paket Desember - December Package) and PakMar (Paket Maret March Package). These packages in principle complement to 1983 policy, but their impacts are more effective for the economy, especially financial system in Indonesia. Share market and banks are more liberal than ever in Indonesian economic history. Economy boomed once again, growth rate reached 7 per cent; this time not because of oil, but due to revitalization of the domestic market.

Nevertheless, deregulation policy is threatened to have adverse effects after a tight-money policy introduced by government, known as "Gebrakan Sumarlin" (Sumarlin Shock).* The purpose of this policy is to reduce the rising inflation rate as a result of high level consumption. Despite the stated objective, this policy seems to have a negative effect on the economy, especially the growth rate.

Having dealt on this background, the objective of this paper is to examine the implication of adjustment policies for some areas of Indonesian economy. The sources used in this paper are mostly secondary ones, since it would be very difficult to have data from the primary sources. However, those secondary sources have been classified to exclude estimation by the author of the articles/book.

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* Named after Johannes Baptisda Sumarlin, Ministry of Finance in Soeharto fifth cabinet (1988-1993).

II. BACKGROUND OF INDONESIAN ECONOMY

Before we probe into adjustment policies taken by government in 1980s, it is useful to see firstly the background of Indonesian economy, based on Five-Year Development Plans.

Indonesian economy since 1968 follows the track of development laid down by the "New Order" government. After years of austerity under Soekarno administration Soeharto government initially gave economic "stabilization, rehabilitation, development" priority over all other objectives. The group of economists who were later denounced as the "Berkeley Mafia"[5] were put in charge of economic policy. They adopted an unambiguously development -oriented strategy and, rather more market-oriented policies.[6]

The first Five Year Plan, which came into force on 1

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[5] "Mafia Berkeley" is the nickname given for Soeharto's elite "technocrates", the leading economists who play an important role in designing the government economic policies. Initially graduates from Universitas Indonesia (Indonesian University, Jakarta) some of them were then really graduates from Berkeley University, California, while the others are from different universities. However they shared similar perspective on economic development in Indonesia. - See Richard Robinson, Indonesia: The Rise of Capital (Sidney: Asian Studies Association of Australia, 1983).

[6] H.W. Arndt, The Indonesian Economy: Collected Papers (Sidney: Chopmen Publishers, 1984), p.78. See also Bruce Glassburner, ed. The Economy Indonesia: Selected Readings (New York: Cornell University Press, 1971), p. 423.

April 1969 continued this strategy, with priority for agriculture and agro-based industries. Modern sector growth got under way during this plan period, supported by foreign aid and foreign direct investment, and a great deal of money was made by civil and military power holders and their business associates.

The second Five Year Plan (1974-1979), responded to earlier criticism of the first plan and emphasized those "problems which were recognized but could not be overcome in the first Plan, such as widening opportunities for employment, more equitable distribution of income, improvement of the market structure, increased development in the regions, transmigration, greater participation of the people in the development, more attention to education and other non-economic aspects."[7]

During the implementation of this Plan, the oil bonanza became the prime source of state revenue.[8] Money was suddenly available to finance substantial social welfare programmes, such as an expanded "kabupaten"[9] and village public works programme, primary school expansion, greatly increased salaries for school teachers, schemes for community health centres and drinking water facilities in

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[7] Arndt, ibid, p.79

[8] In the wake of the 1973/74 decision of the Arab OPEC member countries to quadruple the price of crude oil, the price of Indonesian crude rose from $ 2.93 in April 1973 to $ 12.50 in June 1974. At one stroke, Indonesia's export earnings more than doubled and government revenue rose by almost 100 per cent.- See Arndt, ibid.

[9] equivalent to district administration in Malaysia.

rural areas, transmigration and associated regional development.

The third plan (1979-1984) further increased the relative emphasis on social objectives. "A more even distribution of the benefits of development in order to achieve social justice for the entire population" is the first of the three principles on which the Plan is based, and greater equality is the theme of all eight paths along which this objective is to be pursued.[10]

When the implementation of the third plan come to the end, the budget revenue had been affected by the decreasing world oil prices. This situation had an implication in the designing of the coming forth plan. The government maintained the emphasis of the plan on the welfare programmes, but with a substantial reduction in the revenue, she had to make an adjustment. The fourth plan was then implemented with new policies of adjustment in many areas.

[10] Anne Booth, "Survey of Recent Development," Bulletin of Indonesian Economic Studies (BIES) 15:2 (August 1979): 30,37

III. THE ADJUSTMENT POLICIES

Indonesia responded to the falling oil prices in 1983, which caused the state revenue to dwindle, by introducing adjustment and stabilization programmes. These programmes were oriented mainly to reduce the economy's vulnerability to external shocks.[11]

The most remarkable aspect of Indonesia's policy response to the oil crises is that it was undertaken voluntarily, quickly and in a balanced fashion.[12] By following conservative fiscal and monetary policies during periods of expansion and recession, Indonesia had managed to avoid accumulating large external and internal imbalances and had maintained the confidence of its creditors. As a result, Indonesia did not require emergency stabilization or structural adjustment loans from the International Monetary Funds or World Bank. Instead, Indonesia adopted a sequence of trade and market liberalizing policies and contractionary budget measures. (For chronology and aspect of adjustments, please see appendix 1.)

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11 Erik Thorbecke, "Adjustment; Growth and Income Distribution in Indonesia," World Development 19:11 (October 1991): 1595.

12 ibid. See also Mohamed Ariff, "Policy Reforms in Indonesia and Malaysia," Journal of Economic Cooperation Amongst Islamic Countries 12 (1991): 11.

IV. REFORM MEASURES AFTER ADJUSTMENT POLICIES

i. Financial Reform

Indonesia started deregulating its economy in 1983 by lifting some regulations in finance sector. It consists of eliminating interest rate and credit-ceiling controls on the operations of the State Banks, introducing new instruments of monetary control and limiting the importance of direct channelling of credits from the Central Bank through the commercial bank.

The financial reform then changed the structure of the Indonesian financial system. Before the reform, the financial system was dominated by the central bank and deposit money banks.[13] Moreover, by financial reform Indonesian monetary authorities have choices of targets and instruments. Following the reform the authorities seem to have shifted from targeting aggregate credit expansion to targeting interest rates, thereby allowing monetary and reserve aggregates to be demand-determined. Financial reform also introduced a new mechanism of monetary control that relied principally on open market operations.

The government seemed to feel that 1983 set of reforms

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13 V. Sundararajan and Lazaros Molho, "Financial Reform and Monetary Control in Indonesia," in Hang-Seng Cheng, ed. Monetary Policy in Pasific Basin Countries (Boston: Kluwer Academic Publishers, 1988), pp.321-352. See also, "Recent Deregulation of the Banking Sector in Indonesia," in Jacques Pelkmans, ed. Privatization and Deregulation in ASEAN and the European Community (Singapore: Institute of SouthEast Asian Studies (ISEAS), 1989), pp.32-55.

was still to be complemented by other measures.[14] In late 1988 authorities announced a broad set of financial reform measures. This time the focus was primarily on the structure of the financial system.

The main aims of this reform are to promote competition, (particularly within the banking sector), to promote public confidence in the banking system (through stronger supervision by central bank), and to promote nationality, internationalization and confidence in the insurance sector. Moreover, it is also oriented toward broadening the range of financial services (by promoting the development of private sector activities in capital markets), developing money markets, both primary and secondary, improving the use of monetary policy instruments, and shifting from fixed to more flexible interest and exchange rates.

The most significant aspects of the October 1988 packages were those that provided new opportunities for engaging in all aspects of financial activity. These reforms also gave a considerable stimulus to the development of the domestic money markets.[15] Both exchange rate and money market interest rate management become more

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14 See Mohamed Ariff, "Policy Reforms in Indonesia and Malaysia," Journal of Economic Cooperation Among Islamic Countries 12 (1991): 11.

15 See David C. Cole and Betty F. Slade, "Financial Development in Indonesia," The Oil Boom, p.93. See also Umar Juoro, "Financial Liberalization in Indonesia; Interest Rates, Money Market Instruments, and Bank Supervision," ASEAN Economic Bulletin 9:3 (March 1993): 5-20

flexible.

ii. Tax Reform

Financial Reform was followed by tax reform in December 1983. The Indonesian parliament approved three laws containing General Tax Provisions and Procedures, Income Tax Law, and Value Added Tax on Goods & Services and Sales Tax on Luxury Goods. A law concerning the Land and Building Tax and Stamp Duty law were passed two years later.[16]

The objective of this tax reform is to overcome many deficiencies in old tax system, such as inadequacy of revenues and its uneven enforcement and compliance. It is also oriented to streamline the tax laws and improve the efficiency of the administrative system charged with the transfer of resources to the public sector. Moreover, with this reform, the government wanted to reduce tax-induced distortions in the allocation of resources, and ensure that the poor not be made worse off as a result of the reform, although the programme was not designed to improve income distribution.[17]

By these reforms, the role of non-oil tax revenue in the revenue structure has increased significantly from 5.7 per cent in 1983/1984 to 8.5 per cent in 1988/89. However, in spite of improvement in tax revenue, Indonesia's

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16 Mukul G.Asher and Anne Booth, "Fiscal Policy," in Anne Booth, ed., The Oil Boom and After, p.43

17 ibid.

reliance on external financing of government expenditure on oil still increased substantially.[18]

iii. Liberalization of investment rules.

Since 1985 the government has been streamlining the investment approval process and loosening investment licensing and other controls. in 1985, the number of requirements for a typical investment application was reduced from 37 to 15.[19] At the same time, the investment licensing board was transformed into a "one-stop" agency for both foreign and local investments. In 1986, investment fields open to private investment were expanded. In the following year, the investment and capacity licensing systems were further liberalized so as to permit automatic approval of capacity expansion up to 30 per cent, and a greater product diversification by defining commodities under a capacity license more broadly. In addition, the validity of the operating license was extended for the entire life of the plant, and additional fields of investment were open to investors, both foreign and domestic. Furthermore, ownership controls were relaxed allowing foreigners to have greater equity if production is export-oriented, prohibition against foreign firms engaging in the marketing of their output was relaxed, and restrictions on foreign firms purchasing domestic inputs

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[18] See, Asher and Booth, ibid, p.48, table 2.2

[19] Mohamed Ariff, ibid.

were removed.[20]

The May 1989 investment package was the most significant of all, as it replaced the previous list of investment fields open to foreign investors, domestic incorporated firms, and local small-scale firms with a "negative list" of sectors in which a firm in a given category is prohibited from investing, the restricted sectors being areas of national strategic interests or preserves of small-scale units.[21]

iv. Trade Reforms.

The trade regime has been the main target of Indonesian policy reforms, although it was a by-product of the reform of the tax system. For it was realized that the simplicity and neutrality of the tax system could not be increased without major changes in the structure of import duties and other trade policy interventions. Sweeping changes in the trade regime since 1985 have been aimed mainly at improving the transparency of the system and encouraging non-oil exports.

In April 1985, the customs service was dismantled and the responsibilities were turned over to a Swiss company SGS. In May 1986, it was announced that exporting firms

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[20] See, Anwar Nasution, "Survey of Recent Development," Bulletin of Indonesian Economic Studies 27:2 (August 1991): 21.

[21] See Mohamed Ariff, ibid; also Mari Pangestu and Manggi Habir, "Survey on Recent Development," Bulletin of Indonesian Economic Studies 26:1 (April 1990): 21.

could import their inputs duty-free. In October 1986, quantitative restrictions on imports were reduced and many Non Tariff Barriers(NTBs) were converted to tariffs. The October 1986 reforms were extended to sensitive items such as steel, further simplifying the conversion of NTBs into tariffs. The December 1987 package contained, among other things, further deregulation of the trade regime making it even more transparent. Significant reductions in NTBs were made through the November 1988 package which abolished the regulation of shipping lanes.[22]

v. Public Enterprise reforms.

The Indonesian attempts at privatizing their public enterprises are only recent and such privatization has taken off the ground. However, the government made an important policy announcement in June 1989, affecting state-owned enterprises. The policy options given to state-own enterprise were (a) sale of shares in the stock market, (b) diversiture through direct equity transfers to third parties and (c) mergers among state enterprises.[23]

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[22] See Mohamed Ariff, ibid.

[23] See also recent study by I Ketut Mardjana, "Policy Changes in Indonesian Public Enterprises during the Old Order and New Order Governments," Asean Economic Bulletin 9:2 (November 1992): 187-206.

V. IMPLICATION OF ADJUSTMENTS FOR SELECTED AREAS

The adjustment policies set by the government have significant implication for the Indonesian economy. Since 1969, Indonesian economy has been undergoing a structural transformation. The structural adjustment policies since the beginning 1980's further accelerated the process of transformation.

Table 1 shows a structural changes in the distribution of sectoral output in Indonesia. As the table shows, agriculture sector has a declining trend in its share throughout the period, while in other sectors, especially manufacturing, there is a rapid increase. In 1991, the manufacturing industrial sector emerged as as the single largest sector in the economy.

Table 1
Change in Sectoral Output Distribution
(percent)

Sector	1967	1971	1977	1980	1983	1984	1985	1986	1987	1988	1989	1990	1991
Agriculture	51.3	44	34.7	31.4	22.3	22.2	22.6	21.9	21.3	21.1	20.5	19.58	18.5
Mining	3.7	9.9	12.2	9.4	20.8	20.6	18.2	18.1	17.3	17.3	15.5	15.9	15.7
Industry	3.4	3.8	11.9	14.3	12.8	14.6	15.9	16.3	17.2	17.2	18.7	19.3	20.2
Construction	1.6	3	4.6	5.7	5.9	5.3	5.3	5.1	5.1	5.1	5.4	5.82	6.1
Trade	15.8	16.7	16.2	15.4	14.5	14.2	14.9	14.9	15.2	15.2	16	16.15	16.6
Government	5.5	5.9	3	3.8	7.4	7.2	7.6	7.6	7.8	7.8	7.8	7.61	7.4
Service	6.4	4.5	3.3	2.9	3.9	3.8	3.7	3.7	3.6	3.6	3.5	3.45	3.5
Others	6.8	7.2	9.1	11.4	11.5	12.1	11.8	12.4	12.5	12.5	12.6	12.9	12.0
Total	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0

Source: Sjahrir, <u>Refleksi</u>, p.14

The structural transformation is clearer when the sectors are classified into a broader division. (Table 2). The ratio between primary to secondary sector decreases drastically from 5.5 to 1.5, while that of the tertiary sector has been increasing from 5.5 to 1.4.

Table 2
Structural Transformation in Indonesia
(Percent)

Sector	1967	1971	1977	1980	1983	1984	1985	1986	1987	1988	1989	1990	1991
Primary	55.5	53.9	46.9	40.8	43.5	42.8	40.9	40	38.7	37	36	35.1	34.20
Secondary	10	11.8	16.5	20	18.7	19.9	21.1	21.4	22.3	22.5	24.1	25.74-	27.01
Tertiary	34.5	34.2	36.6	39.2	37.3	37.3	38	39.6	39	40.5	39.9	39.16	38.79

-Primary sectors include agriculture, poultry, forestry, and fisheries.
Secondary sectors include processing industries, electricity, gas, water and construction.
Tertiary sectors include transportation, communication, government, defence and others.
-Counted as percentage of GDP.
Source : Sjahrir, Refleksi, p.14, 15, and 17.

The adjustment programmes have other significant effects on other government programmes which have been initiated before. Below we discuss the effects of such programmes on poverty alleviation, income distribution, employment, health care, inflation, and foreign debt.

1. Poverty alleviation.

Policies on poverty alleviation had been initiated before adjustment policies are implemented. Those policies were the realization of the 2nd five-year plan which came into effect in 1974. The adjustment programmes have been accelerating this process.

A study by Ravallion and Huppi[24] found that the incidence of poverty was found to be significantly lower in both urban and rural areas in 1987 than in 1984. The proportion of the population below the poverty line fell from 33 % in 1984 to slightly over 20 % by 1987.

Total Indonesian poor population, according to 1990 survey is 27.2 million, from which 17.8 is in rural and the rest is in urban area. This figure decreased compared to 30 million in 1987 and 35.1 million in the previous year. (Table 3).

Table 3
Rural-Urban Poverty Map
(million)

Year	Urban	Rural	Total
1976	10.0	44.2	54.2
1978	8.3	38.9	47.2
1980	9.5	32.8	42.3
1981	9.3	31.3	40.6
1984	9.3	25.7	35.0
1987	9.7	20.3	30.0
1990	9.4	17.8	27.2

Source : Tempo, 15th Mei 1993.

The table also indicates a rapid decrease in poverty in rural area, while there is no apparent change in urban. The reason is that between 1980 to 1987 there is a

24 Monika Huppi and Martin Ravallion, "The sectoral structure of Poverty During Adjustment Period : Evidence for Indonesia in the mid-1980s," World Development 19:12 (December 1991): 1653-1678.

declining inequality in rural areas[25], while in urban areas, the population has been increasing more rapidly.

There are questions regarding the validity of data released by the government, especially on the measurement. According to an economist, 1990 survey tends to underestimate the poor, making their absolute number to be smaller than if other measurement were used.[26] In 1987, when the government used the same method as used by the World Bank, the similar result was obtained.[27] Therefore, the data on poverty for 1990 still await a revision.

2. Income Distribution

The sensitive and long-time debated issue in Indonesia include income distribution. There is an argument that adjustment policies taken by the government result in a widening gap between low-income and high income classes. Study by Anne Booth on urban percapita expenditure might provide support for the argument. The study found that the ratio of urban consumer expenditures to those in rural areas increased by almost 35 percent between 1969 and 1987.[28]

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25 Anne Booth, "Income Distribution and Poverty," in Anne Booth, ed. The Oil Boom and After, p.335, table 10.7

26 The same doubt is raised by Anne Booth, ibid.

27 Sjahrir, "Antara Statistik dan Nurani," (Between Statistics and conscience) Tempo, 23 October 1991, p.33

28 Anne Booth, ibid, p.329, table 10.1

Table 4 shows that the increase of the population above the affluence line[29] in rural area is relatively slow compared to the urban area. In Java, the increase was only 0.3% from 1969/70 to 1976, 2.6% in 1981 and 4.6% in 1987. By contrast, in urban area the increase is faster, 7.5 %, 8.8% and 15.7% respectively. The figure is relatively slower in outer islands, and nearly remains unchanged for their rural areas between 1981 and 1987.

Table 4
Percentage of Population above the Affluence Line in Java and the outer islands

	Java		Outer islands	
	Urban	Rural	Urban	Rural
1969/70	7.8	2.3	8.5	7.2
1976	15.3	2.6	10.1	11.5
1981	24.1	5.2	15.2	9.7
1987	39.8	9.8	22.6	9.0

Source : Anne Booth, The Oil Boom and After, p.346

With a closer look on household income (table 5), one will find that nominal income has doubled within six years, from 1976 to 1982. With annual inflation around 9% on average,[30] this increase was actually reduced to its half. As for income classes by educational attainment, the

[29] The setting of affluence line might be subject for discussion since it was set on nominal income. This amount continues to change with respect to the inflation rate at the time of account. See Anne Booth, ed. The Oil Boom and After, p. 346.

[30] Peter G.Warr, "Exchange Rate Policy, Petroleum Prices, and the Balance of Payments," in Anne Booth, ed. The Oil Boom and After, p.138, table 5.2.