

# PERSPECTIVE

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**Singapore** | 19 January 2016

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## **Indonesia's 2016 Budget: Optimism Amidst Global Uncertainties**

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### **EXECUTIVE SUMMARY**

- Indonesia's 2016 budget shows continued domestic optimism amidst global economic uncertainties. The economic growth target has been adjusted downward due to the adverse external environment but it remains optimistic about the country's overall growth potential.
- China's economic slowdown; lower commodity prices; the increase in currency and financial market volatility; and higher external borrowing costs are factors that pose considerable risks to Indonesia's economy.
- Meanwhile, the reallocation of fiscal resources from energy subsidy to infrastructure, health and social assistance programmes is expected to support growth in 2016.
- The 2016 budget also marks a significant rise in the central government's transfers to local governments, which shows political commitment to push further the process of fiscal decentralization.
- Going forward, the government needs to focus on achieving budget optimization through improved revenue collection and more effective budget execution; refining spending quality; and finally, empowering local government towards effective use of greater regional and village funds.

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## INTRODUCTION

The Indonesian Parliament has approved the 2016 budget, which was prepared entirely by President Joko “Jokowi” Widodo’s administration.<sup>2</sup> Concern about declining growth since the end of the commodity boom in 2011 has prompted the government to increase public spending in order to maintain growth in the coming year. The new budget sets its economic growth target at 5.3 percent in 2016, up from 4.7 percent in 2015, which was the lowest level in a decade.

Given that exports and investments are expected to remain subdued due to the weak global economy, public sector spending is expected to be the main driver of growth in the short term. Jokowi has commenced the construction of several key infrastructure projects, such as the building of roads, ports, dams, and power plants, across the archipelago. Moreover, to attract investments into the country, the government has introduced a series of economic packages aimed at cutting down the costs of doing business and at improving the business climate.

Amidst continued global uncertainties and the weakened domestic economy, 2016 will be a challenging year for Indonesia. Last year, public spending failed to act as a growth catalyst. This year, however, the expectation that the public sector will deliver the needed boost to the economy is higher. This essay critically examines Indonesia’s 2016 budget, and specifically discusses key components and new trends that are notable in it, as well as the key challenges faced by the Jokowi’s administration in achieving its development targets.

## BUDGET ASSUMPTIONS & COMPOSITION

On October 30<sup>th</sup> 2015, the government, represented by the Finance Minister, and the House of Representatives (DPR) Commission XI overseeing the State Budget, reached agreement on the overall composition of the 2016 state budget. This was key because without Parliament’s approval, the government would not have been able to proceed on its budget goals. The DPR’s approval of the 2016 budget showcased Jokowi’s administration growing ability to navigate party politics and get legislation passed. This also suggests that Jokowi is becoming more dexterous in handling the levers of power.

The parliamentary debate was lengthy, nevertheless. The 2016 budget had been prepared with several underlying assumptions, including 5.3 percent economic growth,<sup>3</sup> 4.7 percent inflation rate, and 5.5 percent three-month treasury bills rate (Table 1). It is worth noting that the growth rate target was adjusted downward in response to the adverse external environment.<sup>4</sup> In addition, the government and the parliament agreed to assume a weaker

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<sup>2</sup> The 2015 Budget was a transition budget. It was initially prepared by the SBY’s administration, and then amended by the Jokowi’s administration in February 2015 to incorporate the vision and mission of the new President, and adjusted to suit the new ministerial structure.

<sup>3</sup> The 5.3 percent growth assumption is lower than the initial draft proposed in August 2015 (5.5 percent).

<sup>4</sup> World Bank (2015b).

rupiah-US dollar exchange rate, i.e. Rp 13,900 per dollar for 2016, weaker than the initial target of Rp 13,400 per dollar stated in the August 2015 draft.

Compared to last year's budget, the 2016 budget contains improvements in the composition of central government's spending, and shows a commitment for continuing fiscal reform to improve efficiency and quality of public spending. The improvements include further reduction in energy subsidies as well as more spending on health, infrastructure and social assistance programmes.

*Table 1: Indonesia's Budget Assumptions 2014, 2015 and 2016*

<b>Macroeconomic assumptions</b>	<b>2014 Realized</b>	<b>2015 Revised state budget</b>	<b>2016 Proposed state budget</b>	<b>2016 Approved state budget</b>
Growth (%)	5.0	5.7	5.5	5.3
Inflation (%)	8.4	5.0	4.7	4.7
Rupiah per US \$	11,878	12,500	13,400	13,900
Three-month treasury bills (%)	5.8	6.2	5.5	5.5
Budget deficit (%)	-2.2	-1.9	2.1	2.1
Oil price (US\$/barrel)	97.0	60	60	50
Oil lifting (000 barrel/day)	793.5	825	830	830
Gas lifting (000 boe/day)	1,224	1,221	1155	1155
<b>Development targets</b>				
Unemployment rate (%)	5.7-5.9	5.6	5.2-5.5	5.2-5.5
Poverty rate (%)	9-10.5	10.3	9-10	9-10
Gini ratio index		0.40	0.39	0.39
Human Development Index		69.4	70.1	70.1

*Source: Ministry of Finance*

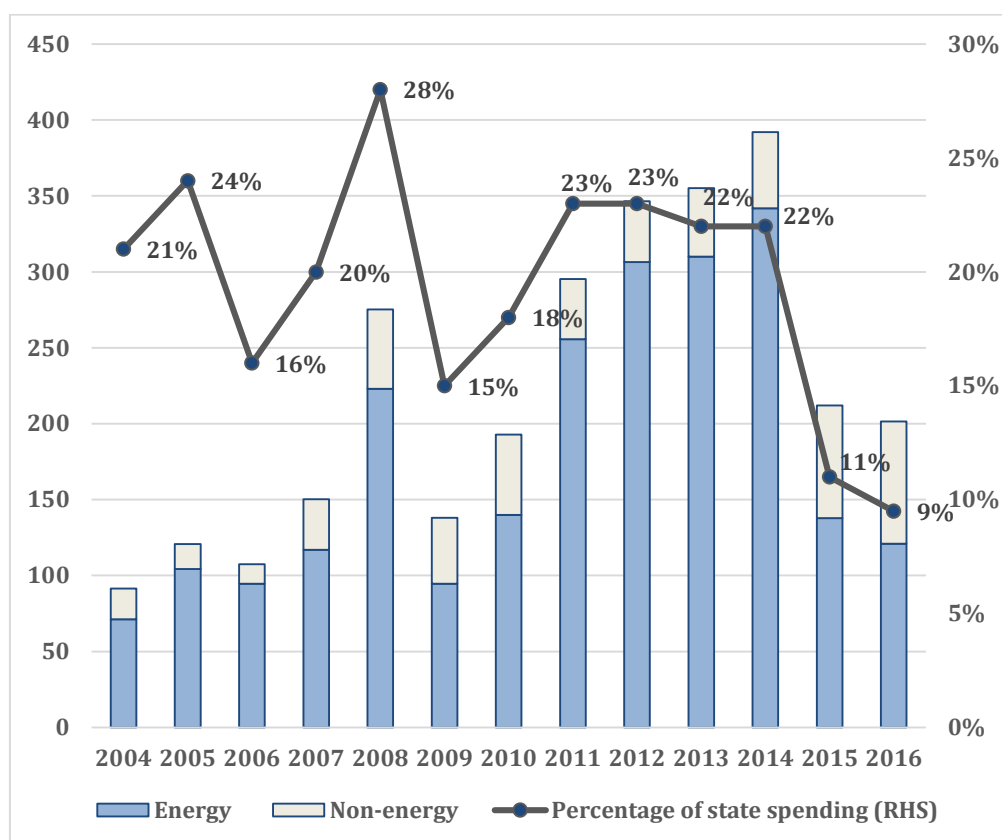
Figure 1 shows that the budget allocation for energy subsidy is set to decline by 12 percent from Rp 138 trillion in 2015 to Rp 121 trillion in 2016. Meanwhile non-energy subsidies<sup>5</sup> are increased by 9 per cent from Rp 74 trillion in 2015 to Rp 80.4 trillion in 2016. Overall, the percentage of central government subsidy to total state expenditure decreases from 11 percent in 2015 to 9 percent in 2016 (Figure 1).

The government's decision to remove the subsidy for gasoline completely has created much needed fiscal space for other more productive spending, such as infrastructure development, health sector and other social assistance programmes.<sup>6</sup> As figure 2 shows, in 2015 Jokowi's administration increased spending for infrastructure, food security and health sector by 63.2%, 84.6% and 21.4% respectively. This year, public expenditure on infrastructure and health is increased further by 8 percent and 42.8 percent respectively.

<sup>5</sup> Non-energy subsidies include rice, fertilizer, seeds, public transport, small-medium enterprises loans, tax, etc.

<sup>6</sup> Beyond creating the needed fiscal space, by fixing the amount of energy subsidy, the government can minimize its fiscal vulnerability against oil price and rupiah fluctuations.

Figure 1: Indonesia's Energy and Non-Energy Subsidy, 2004-2016 (Rp Trillion)



Source: Ministry of Finance

For the first time, public expenditure on health is expected to reach 5 percent of the total state budget, the minimum health share target mandated by Law 36/2009.<sup>7</sup> The higher level of health expenditure is needed to support the national health insurance programme or *Jaminan Kesehatan Nasional* (JKN), which was launched in January 2014. The JKN is a national health insurance system aimed at providing universal access to healthcare by 2019.<sup>8</sup> In addition to the significant rise in health spending, the 2016 budget also continues the ‘20 percent rule’ for the education sector.<sup>9</sup> This rule has been maintained since 2009.

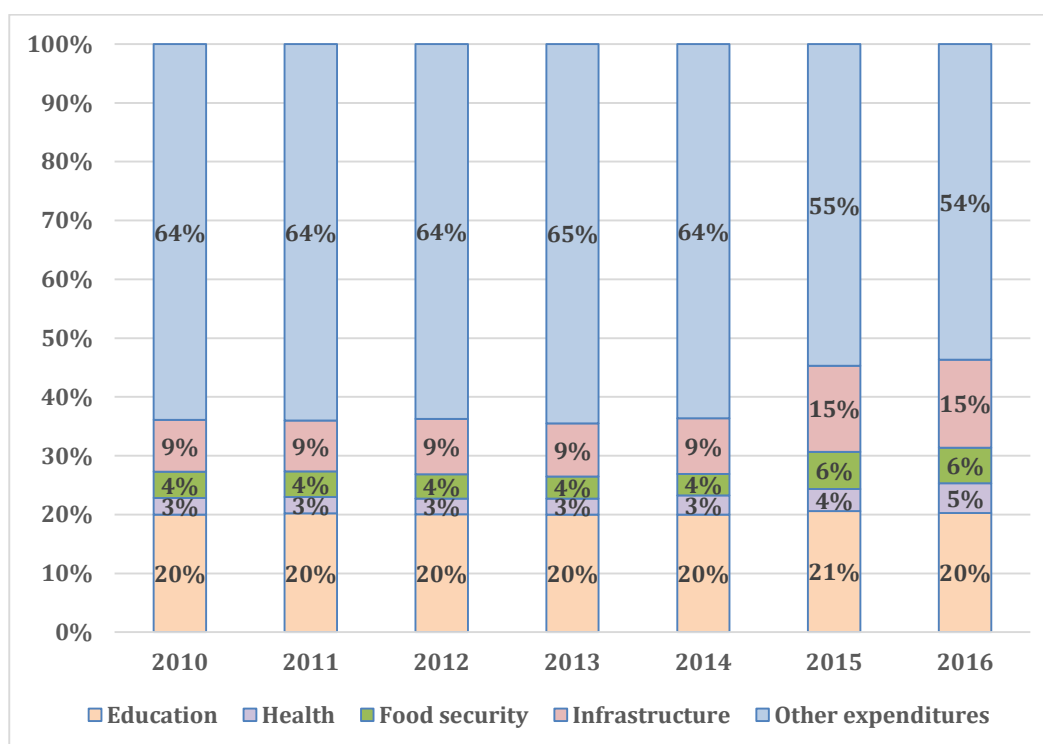
Since Jokowi came to power in October 2014, much of the government’s focus has been on infrastructure development. The increase in infrastructure spending since 2015 has been made possible by the creation of additional fiscal space from the diversion of energy subsidy to capital expenditures. In the 2016 budget, infrastructure spending accounts for around 15 percent of the total state budget, amounting to Rp 313.5 trillion (Figure 2). This is a significant increase from the 9.5 percent allocation in 2014.

<sup>7</sup> World Bank (2015b), p.13.

<sup>8</sup> World Bank (2015a), p.24.

<sup>9</sup> Article 49 of the Law 20 year 2003 on national education system has mandated the government to provide at least 20 per cent of the state budget for education.

*Figure 2: Indonesia's Key Thematic Expenditures, 2004-2016 (% of total budget)*



Source: Ministry of Finance

## FISCAL MANAGEMENT

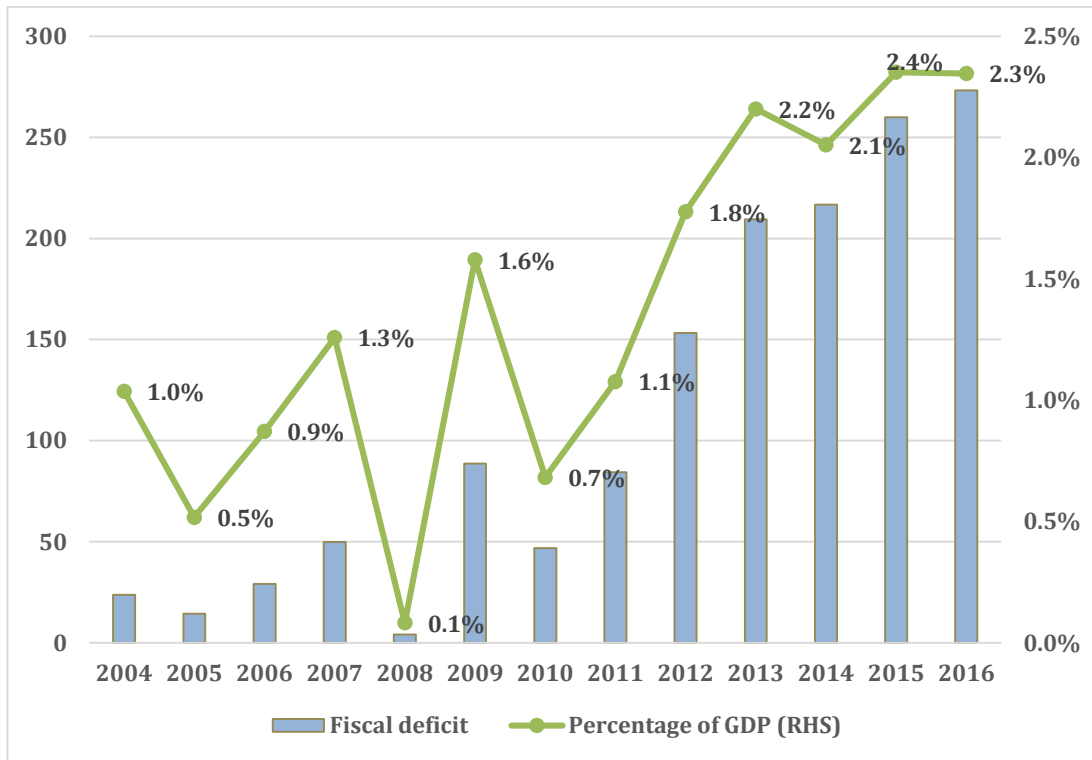
Fiscal prudence is a long established tradition in Indonesia, dating back to the era of Suharto. In keeping with this tradition, the 2016 budget holds the fiscal deficit below 3 percent of GDP, a limit mandated by Law 17/2003 on state financing.

Indonesia has seen an increasing trend in its fiscal deficit, which has gone from 0.68 percent of GDP in 2010 to around 2.1 percent in 2014 (figure 3). Before 2015, this deficit was mainly accounted for by energy subsidies. In 2015, the deficit was mainly attributed to the acceleration in infrastructure development and social assistance programmes.

The 2016 budget targets state revenue to increase by 3.5 percent, to reach Rp 1,822.5 trillion (US\$ 131 billion). About 85 percent of the state revenue will come from taxes. Meanwhile, state expenditure is set to increase by 5.6 percent in 2016, to reach Rp 2,095.7 trillion (US\$ 151 billion).<sup>10</sup> The overall budget deficit in 2016 is thus expected to reach 2.2 percent of the GDP.

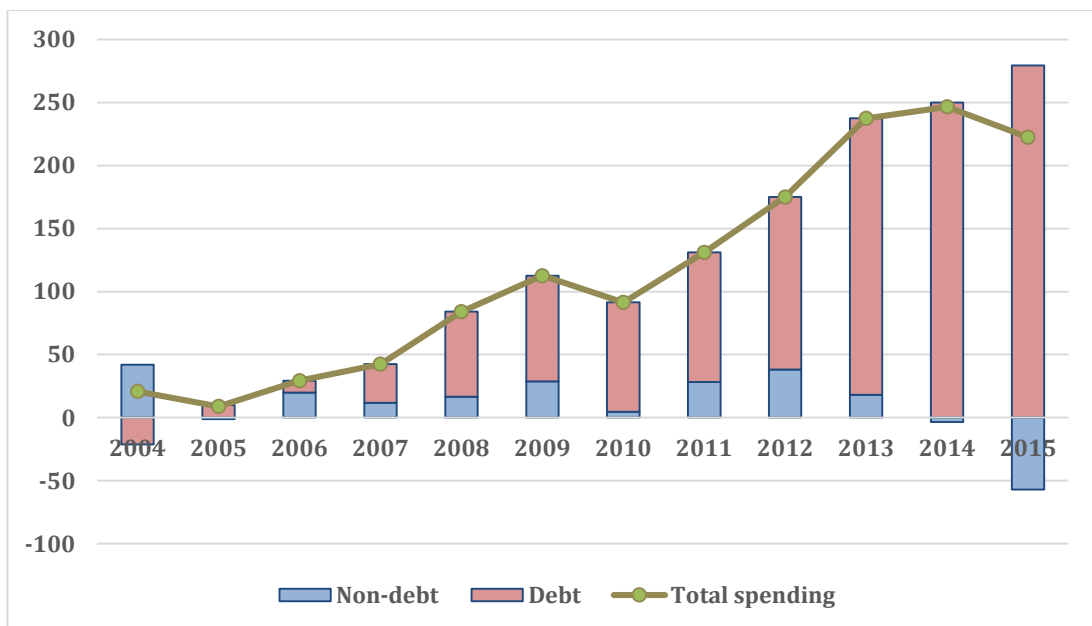
<sup>10</sup> For detailed breakdown see Table 1 in Appendix.

Figure 3: Indonesia's Fiscal Deficit, 2004-2016 (Rp Trillion)



Source: Ministry of Finance

Figure 4: Indonesia's Budget Financing Source, 2004-2016 (Rp Trillion)



Source: Ministry of Finance

The budget deficit is expected to be closed by financing sources from within and outside the country. Figure 4 illustrates that Indonesia's debt financing has been increasing

significantly from around Rp 80 trillion in 2010 to Rp 280 trillion in 2015. Recently, the risks to financing the deficit have become more pronounced due to the tightening on the global financial market (causing a rise in borrowing costs), which has affected all emerging economies. Tighter global liquidity will put extra pressure on Indonesia's financial market, where foreign ownership of equities and bonds is relatively high.

## FISCAL DECENTRALIZATION

Arguably the most salient feature of the 2016 budget lies in the greater fiscal decentralization. The new budget reflects the government's intention to push for 'development from the periphery' and to fully implement regional autonomy and decentralization.<sup>11</sup> As can be seen in Figure 5, Transfer to region has been gradually increasing since 2013. It accounted for 33 percent of total state spending in 2015. And in 2016, this figure is set to reach 37 percent, a dramatic rise from last year's allocation. Compared to the 2015 revised budget, the central government's transfer to local government is increased by 15.9 percent to Rp 770.2 trillion (including Rp 47 trillion for village funds).<sup>12</sup> On the contrary, total line ministry spending is set to contract by 15 percent in 2016 to reach Rp 784 trillion.

Greater fiscal decentralization will increase Jokowi's popularity, especially among people in rural areas. Thus, it will further strengthen his power levers. However, the economic impact of this policy will depend on the effectiveness of its implementation. The policy can only be fruitful if there is sufficient institutional capacity at the local level to follow up with appropriate policies, good supporting regulatory framework and proper accountability in the using of the local budget. Most of these are currently lacking and need serious technical assistance from the central government to regional and village heads to remedy.

Another source of concern are the many cases of corruption involving local leaders and politicians.<sup>13</sup> Greater fiscal transfers can potentially be abused within the budget-making, procurement and license-granting processes. Without a good oversight mechanism, the greater fiscal allocations may not improve society's welfare. A better monitoring and reporting mechanism to ensure good standards of public accountancy is therefore needed.

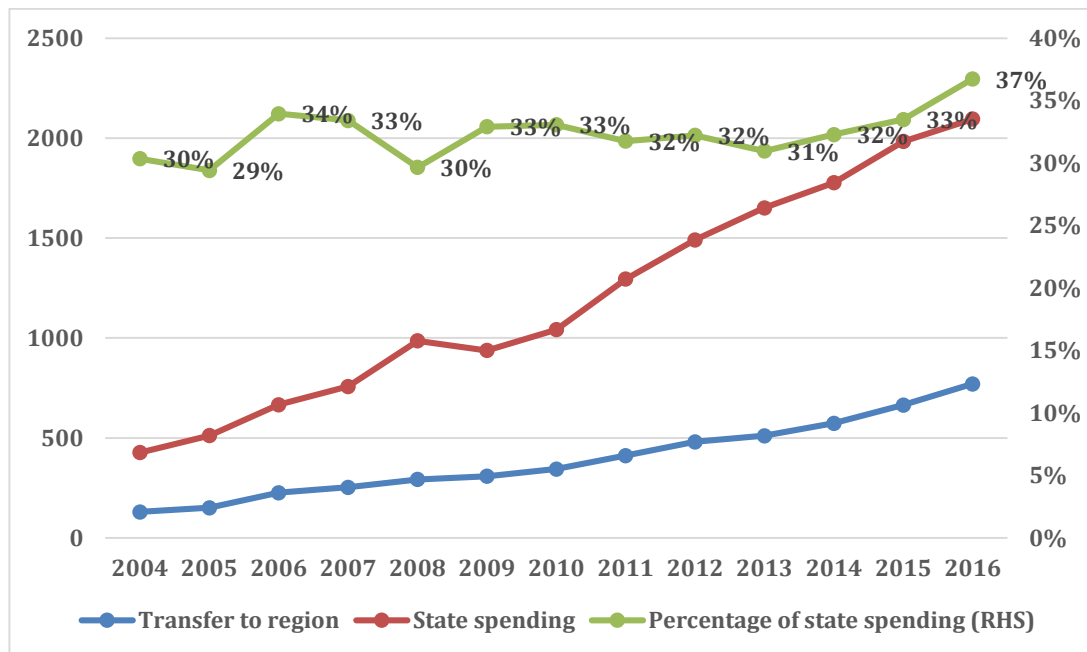
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<sup>11</sup> Kompas, "Pendulum Anggaran Mulai ke Daerah", 15 August 2015, <http://print.kompas.com/baca/2015/08/15/Pendulum-Anggaran-Mulai-ke-Daerah>.

<sup>12</sup> See Table 1 in Appendix.

<sup>13</sup> Kompas, "Mendagri: 343 Kepala Daerah Tersangkut Kasus Hukum", 4 February 2015, <http://nasional.kompas.com/read/2015/02/04/21114211/Mendagri.343.Kepala.Daerah.Tersangkut.Kasus.Hukum>

Figure 5: Transfer to Region and Total State Expenditure, 2004-2015



Source: BPS. Author's calculation.

## MINISTERIAL SPENDING

This section examines some major trends in terms of ministerial allocation in the 2016 budget. It is important to note that when Jokowi came to power, he restructured several ministries. One example is related to the reorganisation of Ministry of Education. Jokowi decided to move the higher education directorate general from the Ministry of Education to the Ministry of Research and Technology. This change has resulted in significant budget shift from the Ministry of Education to the Ministry of Research and Technology. As a result the budget for the Ministry of Education dropped from 4.3 percent of the 2014 budget to 2.7 percent of the 2015 budget (Table 2). In 2016, the Ministry of Education's budget declines further to 2.3 percent of the total budget. An interesting trend is that, since 2015, the Ministry of Education has received smaller budget compared to the Ministry of Religious Affairs. This trend deserves further scrutiny, whether the public fund is properly channelled to improve the quality of many religious schools in the country.

Another reorganisation took place in the Ministry of Public Works and the Ministry of Public Housing. Jokowi decided to merge the two ministries in order to integrate his ambitious initiative called 'One Million Homes' (*Satu Juta Rumah*) into the overall infrastructure development plan. As a result of the merger, this ministry becomes the biggest recipient of the 2015 and 2016 state budget with total budget amounting to Rp 118.5 trillion (US\$ 9.5 billion) and Rp 104.1 trillion (US\$ 7.5 billion), respectively (Table 2).



*Table 2: Ten Biggest Recipient of Indonesia's State Budget, 2014, 2015, 2016*

	Ministry/Government Agency	2014		2015		2016	
		Rp (trillion)	% of budget	Rp (trillion)	% of budget	Rp (trillion)	% of budget
1	Public works and housing	84.1	4.5	118.5	6.0	104.1	5.0
2	Defence	86.4	4.6	102.3	5.2	99.5	4.7
3	Police	45	2.4	57.1	2.9	73	3.5
4	Health	46.5	2.5	51.3	2.6	63.5	3.0
5	Religious affairs	42.6	2.3	60.3	3.0	57.1	2.7
6	Education and culture	80.7	4.3	53.3	2.7	49.2	2.3
7	Transportation	40.4	2.2	65	3.3	48.5	2.3
8	Research and technology	0.6	0.03	43.6	2.2	40.6	1.9
9	Finance	18.7	1.0	25.7	1.3	39.3	1.9
10	Agriculture	15.5	0.8	32.8	1.7	31.5	1.5

*Source: Ministry of finance*

After the Ministry of Public Works and Public Housing, the Defence Ministry and Police are those who receive the second and third largest allocations in the 2016 budget. In 2014, it was the Ministry of Defence that was the biggest recipient of state spending. Higher defence budget is needed to improve Indonesia's Minimum Essential Forces (MEF) capacity. At the same time, increased security risks such as internal conflicts, border disputes, terrorism and transnational security issues, have caused the Jokowi administration to increase spending for the national police by 42 percent in the 2016 budget.

## CHALLENGES

Global economic uncertainty poses significant risks to Indonesia's growth outlook. The main risk is expected to stem from China's further economic slowdown in 2016. China has been a major export partner for Indonesia for more than two decades. Exports to China accounts for around 13 percent average share in Indonesia's total exports.<sup>14</sup> It is estimated that weak Chinese demand contributed 2.7 percentage points to the annual decline in Indonesian exports.<sup>15</sup>

In the currency market, the key challenge for Indonesia's economy in 2016 is related to the sharp depreciation of Rupiah. Pressure on the rupiah is expected to persist until the first quarter of 2016 due to the Fed's interest rate hike plan. Moreover, the normalisation of the US monetary policy will tighten global liquidity and cause asset prices corrections.

<sup>14</sup> Cassey Lee, forthcoming, "Southeast Asian Economies Coping with Adverse Global Economic Conditions", in *Southeast Asian Affairs 2016* edited by Daljit Singh and Malcolm Cook.

<sup>15</sup> World Bank (2015a), p. 10.

Emerging markets like Indonesia are expected to experience a destabilization in capital outflows.

Amidst a challenging global environment, Indonesia needs to continue its supply-side reforms to raise business and consumer confidence. The Jokowi administration has announced a series of policy packages between September 9 and December 21, 2015, meant to cut red tape and lower business costs. They include removing unnecessary requirements for import and export licenses, simplifying investment licensing through a one-stop service system, reducing energy prices for industry, introducing formula-based minimum wages, expediting the application process for land use permit, and expanding export financing for SMEs.<sup>16</sup> It remains to be seen how much impact these reform packages will have on the economy.

Since Indonesia's monetary policy is expected to remain tight in response to the possibility of further financial market volatility related to the US monetary policy normalization, its fiscal policy should play a bigger role in boosting growth. However, weak revenue collection poses a serious challenge to fiscal policy optimization.<sup>17</sup> Last year, tax revenue realization reached only around 82 percent of the of the tax revenue target (Table 3).<sup>18</sup>

*Table 3: Indonesia's Tax Revenue Realization, 2005-2015 (Rp trillion)*

	<b>Target</b>	<b>Realization</b>	<b>Percentage</b>
2005	298	295	99%
2006	370	355	96%
2007	423	419	99%
2008	528	565	107%
2009	572	538	94%
2010	646	620	96%
2011	780	764	98%
2012	962	904	94%
2013	991	922	93%
2014	1082	985	91%
2015 <sup>*)</sup>	1294	1,060	82%

*Note: \*) Tax revenue target for 2015 has been revised downward from Rp 1,489.3 trillion to Rp 1,294 trillion.*

*Source: Government Financial Report (LKPP)*

<sup>16</sup> For explanation of each of the policy package, see Arif Gunawan S. & Ayomi Amindoni, "Year in review: Never too late for economic stimuli", The Jakarta Post, December 28 2015. <http://www.thejakartapost.com/news/2015/12/27/year-review-never-too-late-economic-stimuli.html#sthash.W6StEgBD.dpuf>

<sup>17</sup> World Bank (2015b), pp.10-11.

<sup>18</sup> The poor realization of the tax target has forced Mr Sigit Priadi Pramudito, the Head of the Tax Office, to resign.

Given the poor tax realization last year, the 2016 tax revenue target has been criticized as being too optimistic.<sup>19</sup> With the bleak global economic outlook and structural challenges in the domestic economy, the government should possibly lower its tax revenue target in 2016. Weaker revenues collection will reduce the room for fiscal expansion and force an unwinding of the government's capital spending. To reach the 2016 revenue target, the government will need to improve its tax collection efforts. This will include broadening the tax coverage, improving tax compliance and preventing leakages.

From the spending side, acceleration of spending will be a test case for the Jokowi administration. Despite Jokowi's instruction to the ministries to expedite budget disbursement, various bureaucratic constraints remain and delay the process. The current practice of back-loading projects spending at the last quarter of the year may adversely affect project quality. This year, the government should seriously improve the process of budget disbursement, develop procurement efficiency and speed up the tendering process so that ministries can achieve better planning for their projects.

Finally, to effectively implement fiscal decentralization, there is a need for complementing financial support with institutional capacity. The capacity of local government and institutions needs to be improved so that they can take proactive measures in striking a balance between pursuing the national development plan and preserving local interests. Moreover, with more public resources transferred to local government, robust monitoring and evaluation mechanism are critical. For this, active participation from local stakeholders to ensure public fund is appropriately used, well-targeted and accountable should be encouraged.

## **CONCLUDING REMARKS**

Overall, the 2016 budget shows a continuation of fiscal reform to improve the efficiency and quality of government spending. It proposes larger and better-targeted social programmes and redirects spending away from energy subsidies to infrastructure development, health and other social assistance programmes. The government is allocating 15 percent of the total state budget for infrastructure development. In addition, health spending has been increased significantly to 5 percent of the total state budget.

The 2016 budget also commits the government to push for 'development from the periphery' and to fully implement regional autonomy and fiscal decentralization. There is a significant increase in transfers to local governments by almost 16 percent compared to the 2015 allocation. It thus provides a sound fiscal base for Indonesia to achieve its moderate growth target. However, the outcome will depend on timely and effective implementation of the budget.

There are several external and internal challenges that clouds the growth outlook. Externally, the economy must find a strategy to cope with China's economic slowdown; lower commodity prices; increased currency and financial market volatility; and higher

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<sup>19</sup> See Arif Gunawan S. & Anton Hermansyah, "Behind tax-shortfall: Rethinking Indonesian taxation", The Jakarta Post, 12 January 2016.  
<http://www.thejakartapost.com/news/2016/01/12/behind-tax-shortfall-rethinking-indonesian->

external borrowing costs. Indonesia can possibly turn China's economic rebalancing into an opportunity if it can diversify its exports away from commodities into manufacturing and services.

Finally, to achieve the development targets stated in the 2016 budget, the government must ensure that it can achieve the targeted fiscal revenues; improve spending quality; and finally, get critical local government buy-in on the national development goals.

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**Appendix:**
*Table 1: Indonesia's Budget Posture, 2014, 2015 and 2016 (Rp trillion)*

	Description	2014 APBNP <sup>1</sup>	2014 Actual	2015 APBNP <sup>1</sup>	2015 Revised Outlook <sup>2</sup>	2016 RAPBN <sup>3</sup>
1	<i>State revenues and grants</i>	1635.4	1550	1761.6	1649.8	1822.5
	- Domestic revenues	1633.1	1546	1758.3	1646.4	1820.5
	Tax revenue	1246.1	1147	1489.3	1367	1546.7
	Non-tax revenue	386.9	399	269.1	279.4	273.8
	- Grants	2.3	4	3.3	3.3	2
2	<i>State expenditure</i>	1876.9	1777	1984.1	1909.8	2095.7
	- Central gov. spending	1280.4	1204	1319.5	1245.5	1325.6
	Ministries/Agencies spending	602.3		795.5	730.1	784.1
	Non-ministries spending	678.1		524.1	515.5	541.4
	- Transfer to region	596.5	574	664.6	664.2	770.2
3	<i>Primary balance</i>	-106	-93	-67	-102.6	-89
4	<i>Overall balance</i>	-241.5	-227	-222.5	-260	-273.2
	Percentage deficit to GDP	-2.4	-2.2	-1.9	-2.2	-2.2

Note: <sup>1)</sup> APBNP is the revised state budget. <sup>2)</sup> MoF's Revised Outlook as of November 2015. <sup>3)</sup> RAPBN is the proposed state budget

Source: Bank Indonesia, Ministry of Finance & World Bank

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