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Indonesia's 2017 Budget Seeks Cautious Economic Expansion

*Siwage Dharma Negara**

EXECUTIVE SUMMARY

- Indonesia's 2017 budget plan reflects an anticipation of sluggish growth in the upcoming year amidst continued global economic uncertainties, low commodity prices, and weak manufacturing-sector growth.

- The government's fiscal policy is set to remain expansionary in order to stimulate the domestic economy. However, given increasing risks of state revenue shortfalls, more budget cuts are to be expected. The government has already adjusted downwards its 2017 state revenues and expenditures targets, which has made its budget more realistic and credible. On the other hand, this may lead to lower economic growth over the next two years.

- The 2017 budget also shows the government's continued commitment to achieve further fiscal decentralization through increased regional transfers and villages funds as mandated by law. However, the outcome will depend on the ability of local governments and institutions to plan and monitor their budgets.

- Indonesia still has ample room for increasing its public debt level for financing key national programmes, but this needs to be managed prudently.

- The government needs to improve tax revenue collection and manage fiscal spending effectively. The impact of a tax amnesty programme in the short term will be negligible, and what is more relevant is an overhaul of the tax administration system, with particular focus on strengthening the powers and the reach of the tax office.

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INTRODUCTION

At the start of his presidency, the then-newly elected President Joko 'Jokowi' Widodo promised to achieve seven percent annual growth within the next three years.[1] Almost two years later, this target seems hard if not impossible to achieve amidst global economic uncertainties and a lacklustre domestic performance. The economy is now struggling to not fall below the five percent growth rate, a critical threshold for keeping Indonesia's 130 million workers gainfully employed. In fact, a five percent growth rate is actually barely sufficient in supporting Indonesia's ambition to eradicate extreme poverty. Around 11 percent of the total population are still living in poverty and mostly in rural areas.[2] Moreover, Indonesia is suffering a huge income inequality. According to its Statistics Agency (BPS), the country's Gini coefficient, an indicator of income distribution, has worsened in recent years.[3]

In order to boost short-term growth, Indonesia relies on public sector spending, which is mainly directed towards infrastructure and social assistance programmes. However, given weaker-than-expected revenues in recent years, there is a risk that the government's fiscal capacity will be increasingly limited going forward.

Announced by Jokowi on 16 August 2016 at the annual meeting of the People's Consultative Assembly,[4] the 2017 budget is constructed amidst great economic and social challenges facing the country. This article examines the key items and trends in the budget and discusses overall fiscal balance, including some key assumptions that have been made; and compares state revenues and expenditures targets to those in the previous budget. The concluding section points out some key challenges faced by the Jokowi administration in consolidating its fiscal policy to support its ambitious national development agenda.

FISCAL BALANCE

The overall theme of the 2017 budget is fiscal consolidation in terms of revenues and expenditures targets. The budget is designed to be realistic, credible and efficient given the

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[1] Kompas, "*Pemerintah Targetkan Pertumbuhan Ekonomi 7 Persen*", 23 December 2014, http://bisniskeuangan.kompas.com/read/2014/12/23/163935126/Pemerintah.Targetkan.Pertumbuhan.Ekonomi.7.Persen. Retrieved 31 August 2016
[2] Kompas, "*BPS: Angka Kemiskinan Turun di Level 10,86 Persen*", 18 July 2016, http://bisniskeuangan.kompas.com/read/2016/07/18/115609826/bps.angka.kemiskinan.turun.di.level.10.86.persen. Retrieved: 18 August 2016
[3] Ayomi Amindoni, "Indonesia's Gini ratio advances to 0.4", The Jakarta Post, 18 April 2016, http://www.thejakartapost.com/news/2016/04/18/indonesias-gini-ratio-advances-to-0-4.html. Retrieved: 18 August 2016
[4] The 2017 draft budget will be discussed with Indonesian Parliament and is expected to be approved by lawmakers in October. The draft itself was prepared by the previous Finance Minister, Bambang Brodjonegoro.

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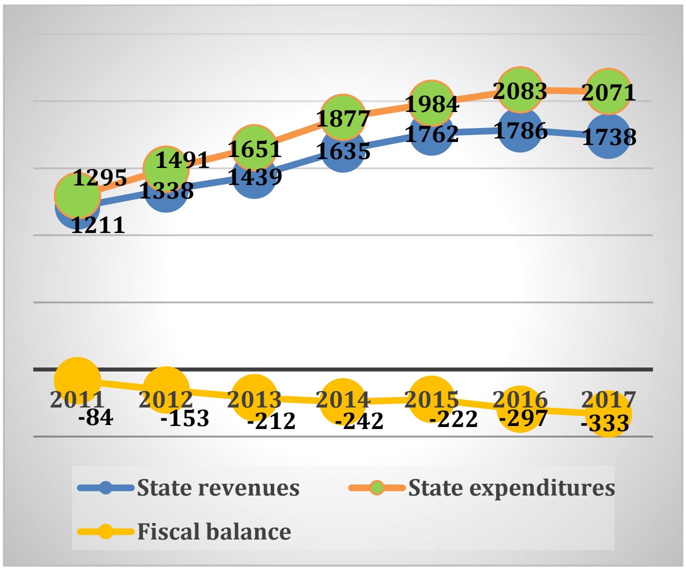
many economic uncertainties the country presently faces. It is more realistic in the sense that, amidst continuing weak global economic conditions and low commodity prices, it no longer sets ambitious growth targets like in previous years. Indeed, the 2017 budget targets a growth rate of around 5.3 percent for next year, not much different from this year's target of 5.2 percent. Moreover, the government expects state revenue shortfalls to continue and hence has cut fiscal expenditures for next year (see Figure 1). Overall, the 2017 budget projects a soaring fiscal deficit as a consequence of lower-than-expected tax revenue alongside the commitment to maintain spending for national priority programmes such as infrastructure and social assistance programmes. The government estimates that the budget deficit will reach Rp 333 trillion, or 2.41 percent of Gross Domestic Product (GDP) in 2017 (Figure 1).[5]

Figure 1: State Revenues, Expenditures, & Fiscal Balance, 2011-2017 (Rp trillion)



Source: Ministry of Finance

Table 1 below shows several key macroeconomic indicators used by the government in the 2017 budget proposal. The growth rate target is set to 5.3 percent, slightly higher than this year's target. The inflation rate is set to remain at 4 percent, similar to this year's target. The interest rate is expected to decline slightly from 5.5 percent to 5.3 percent as the monetary policy is to be loosened up to stimulate the domestic economy. Meanwhile, Indonesia's rupiah is predicted to strengthen marginally at the exchange rate of Rp 13,300 against the US dollar.

[5] Law 17/2003 on state financing sets the limit for budget deficit to 3 percent of GDP.

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Table 1: Indonesia's Budget Assumptions 2016 and 2017

	2016 Approved state budget	2016 Revised state budget	2017 Proposed state budget
GDP Growth (%)	5.3	5.2	5.3
Inflation (%)	4.7	4.0	4.0
Exchange rate (IDR/US$)	13,900	13,500	13,300
SPN Rate (%)	5.5	5.5	5.3
Budget deficit (%)	2.2	2.4	2.4
Crude oil price (US$/barrel)	50	40	45
Oil production (000 barrel/day)	830	820	780
Gas production (000 boe/day)	1150	1150	1150

Source: Ministry of Finance

STATE REVENUE

The major assumptions for determining state revenues concern the price of oil and oil production. For the 2017 budget, the government estimates that oil production will decline from 820 thousand barrels per day this year to 780 thousand barrels next year (Table 1). This reflects Indonesia's depleting oil reserves. Moreover, the price of oil is expected to increase from US$40 per barrel in 2016 to US$45 per barrel in 2017.

Considering the sluggish global economic recovery and low commodity prices, the government thinks that state revenues will only reach Rp 1,738 trillion (US$ 131 billion) in 2017. This projection is 2.7 percent lower than the target in the revised 2016 budget. Most of the state's revenue (Rp 1,496 trillion or 86.1 percent of the total state revenue) is expected to come from tax revenues. However, collected taxes have been below expectations in recent years. In 2015, collected taxes reached around only 83 percent of the target, the lowest in history (Figure 2).

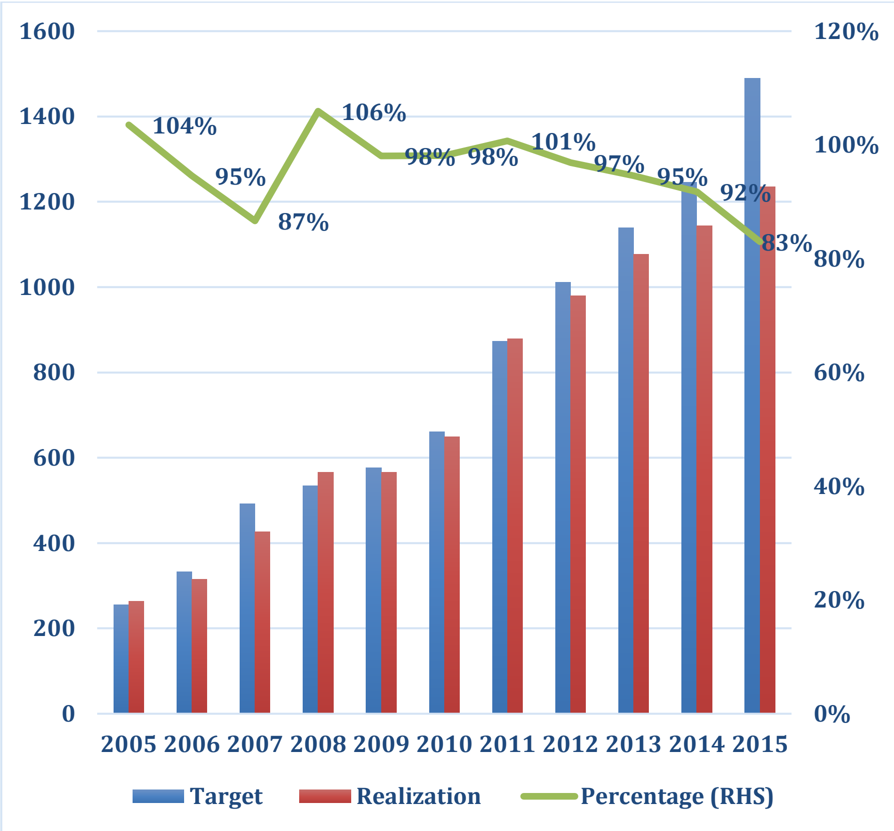
This trend seems to continue this year. As of August 2016 the revenues had fulfilled only 44 percent of the budgeted amount.[6] The poor tax revenues are caused by several factors, including the drop in exports revenues, the weak domestic economy, poor tax administration policies and, one has to assume, unrealistic targets.[7] A recent study indicates that the problem is structural to a larger degree than once thought. This is reflected in how the

[6] https://pengampunanpajak.com/2016/08/30/penerimaan-pajak-hingga-agustus-baru-44/. Retrieved: 9 September 2016

[7] Kahlil Rowter, " A more realistic 2017 government budget", The Jakarta Post, 22 August 2016 http://www.thejakartapost.com/academia/2016/08/22/a-more-realistic-2017-government-budget.html. Retrieved: 22 August 2016

growth of key tax revenues, i.e. the income tax and the Value Added Tax (VAT), are now much lower that before the Asian Financial Crisis.[8]

Figure 2: Indonesia's Tax Revenue Realization, 2005-2015 (Rp trillion)



Source: Ministry of Finance

To meet the tax revenue target, the government has been trying several strategies, including amending tax regulations and the tax amnesty programme.[9] The latter came into effect in July this year and aims to repatriate overseas funds held by rich Indonesians to compensate for the expected shortfall in tax revenues. Moreover, the programme seeks to expand the taxpayer base. Indonesia's tax-to-GDP ratio is only 12 percent, much lower than Malaysia and Thailand's 16 percent. The government has estimated that the tax amnesty programme can raise around Rp 165 trillion (US$12.4 billion), which would increase its revenue by 11

[8] Riatu Qibthiyyah and Ariane Utomo, 2016, "Survey of Recent Developments Family Matters: Demographic Change and Social Spending in Indonesia", Bulletin of Indonesian Economic Studies, vol 52. (2): 133-59.
[9] *Nota keuangan and RAPBN 2017.*

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percentage points.[10] However, Bank Indonesia forecasts that at most, the government will be able to collect only Rp 21 trillion,[11] less than one-fifth of the target Rp 165 trillion.

Despite aggressive campaign by the government, little progress has been made in the programme. As of September 14, total penalty payments stood at Rp 10.3 trillion, which is only 6.2 percent of this year's target of Rp 165 trillion. Meanwhile repatriated funds amounted to Rp 22 trillion, or only 2.2 percent of the targeted Rp 1,000 trillion (US$75.2 billion).[12] These figures are worrying because the first three months of the tax amnesty offered the biggest penalty cuts and were supposed to be the most attractive period for those wanting to join the programme. Finance Minister Sri Mulyani Indrawati expects the figures to rise in September because big taxpayers would by then have completed the legal adjustments needed to participate in the programme.[13]

STATE EXPENDITURE

In order to meet the growth target set in the 2017 budget, the government will implement an expansionary fiscal policy in which spending is expected to be higher than revenue targets. On the expenditure side, the government allocates Rp 2,071 trillion (US$ 156 billion), comprising Rp 1,310 trillion in central government expenditure and Rp 760 trillion in regional transfers and village funds. This projection is 0.6 percent lower than the expenditure target in the revised 2016 state budget.

One can understand the government's priority by looking at its spending allocation. It is keeping to its commitment to shift subsidy spending to infrastructure and to the health and education sectors. Indeed, the percentage of central government subsidy to total state spending has been declining from 22 percent in 2014 to 8 percent in 2017. State spending on infrastructure has been significantly increased since 2015. In 2016, spending on infrastructure is estimated to reach Rp 313.5 trillion (15 percent of the total state budget) (Figure 3). In the 2017 budget, the amount is estimated to increase by 11 percent, reaching Rp 347 trillion (17 percent of total state budget or 3 percent of GDP). Moreover, the

[10] Riatu Qibthiyyah and Ariane Utomo, 2016, "Survey of Recent Developments Family Matters: Demographic Change and Social Spending in Indonesia", Bulletin of Indonesian Economic Studies, vol 52. (2): 133-59.

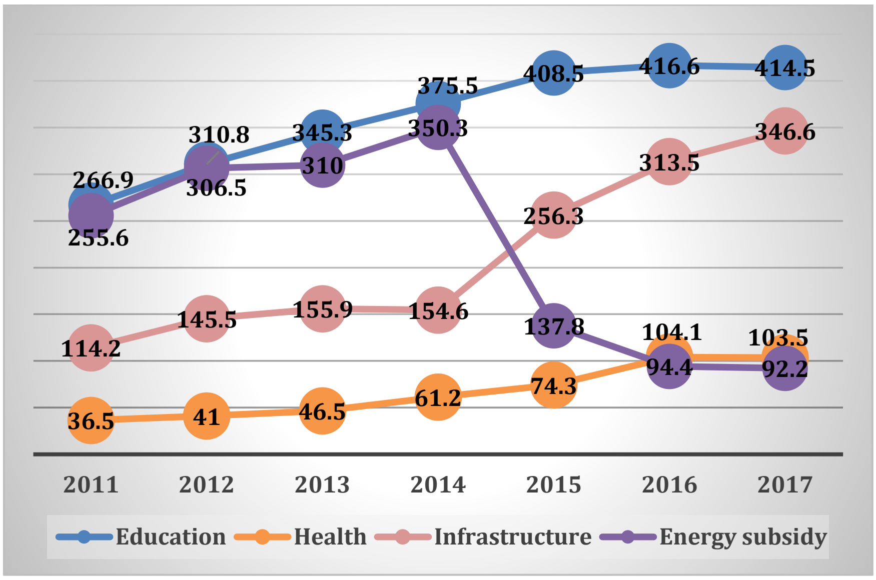
[11] http://bisniskeuangan.kompas.com/read/2016/09/14/155503226/pertengahan.september.baru.127.wajib.pajak.besar.ikut.tax.amnesty.. Retrieved: 15 September 2016.

[12] http://bisniskeuangan.kompas.com/read/2016/09/09/100000526/dari.target.rp.1.000.triliun.realisasi.dana.mudik.baru.capai.rp.15.7.triliun. Retrieved: 9 September 2016

[13] Farida Susanty, "Clock ticking on tax amnesty", The Jakarta Post, 23 August 2016, http://www.thejakartapost.com/news/2016/08/23/clock-ticking-on-tax-amnesty.html. Retrieved 1 September 2016.

government is allocating 20 percent of the total budget to education and 5 percent of the total budget to health care to meet legal requirements.[14]

Figure 3: Shift in State Budget Allocation, 2011-2017 (Rp trillion)



Note: 2016 and 2017 figures are based on projections.
Source: Ministry of Finance.

With infrastructure development placed high on the nation's economic agenda, all the ministries concerned with infrastructure projects have seen their budget increase. The budget for the Ministry of Public Works, the Ministry of Transport and the Ministry of Social Affairs are each increased by 9, 14 and 40 percent respectively (Table 2). Despite the big allocation, however, these ministries seem to have problems with disbursement and programme execution. For example, the disbursement rate of the Ministry of Public Works and Ministry of Transport as of the first semester of this year are only around 29 and 28 percent respectively.[15] This has been partly caused by delays in land acquisition and also by the internal administrative process.[16] Recent cabinet reshuffle in July are expected to accelerate the Ministry's budget disbursement.

[14] Law 36/2009 on National Health System sets the minimum allocation of 5 percent of GDP for health sector spending
[15] http://industri.bisnis.com/read/20160719/45/567091/realisasi-serapan-anggaran-kementerian-pupr-semester-i-capai-2916; http://bisniskeuangan.kompas.com/read/2016/07/25/195419826/realisasi.anggaran.kemenhub.semester.i.2016.sebesar.28.persen.dari.pagu. Retrieved: 20 August 2016
[16] http://properti.kompas.com/read/2016/03/01/163000121/Serapan.Anggaran.Kementerian.PUPR.Baru.4.9.Persen

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Table 2: Recipients of Indonesia's State Budget, 2016- 2017 (Rp trillion)

Ministry/State Institution	2016	2017	Change
Public Works and Housing	97.1	105.6	9%
Defence	108.7	104.4	-4%
Police	79.3	72.4	-9%
Religious Affairs	56.2	60.7	8%
Health	62.7	58.3	-7%
Transportation	42.9	48.7	14%
Finance	43.6	39.8	-9%
Education and Culture	43.6	38.9	-11%
Research, Technology and Higher Education	40.6	39.4	-3%
Agriculture	27.6	23.9	-13%
Social Affairs	13.1	18.3	40%
Marine Affairs and Fisheries	10.6	10.1	-5%

Source: Ministry of Finance

Another key component of state expenditures is related to regional transfers. The government has been trying to further implement fiscal decentralization as mandated by the Law 23/2014 on regional government. As can be seen in Figure 3, transfers to regions have been increasing from around 31 percent of total state spending in 2014 to 37 percent in the 2017 budget plan (Figure 3).

In the 2017 budget, the central government's transfer to the regions is estimated to reach Rp 760 trillion. This figure is lower by 2.1 percent when compared to that in the 2016 revised budget. However, transfers to villages (*Dana Desa*) have increased by almost 30 percent from Rp 47 trillion in the 2016 revised budget to Rp 60 trillion in the 2017 budget.

Increases in transfers to the villages are part of the government's attempt to gradually fulfil what has been mandated by Law No 6/2014 on village development. This law states that ten percent of fund transfers to regions must go to the villages. Since it became effective in 2015, transfers to the villages have been increasing gradually. In 2015, 3.2 percent of transfers to the regions (Rp 21 trillion) went to village funds. For 2016, the figure is set at 6.4 percent (Rp 47 trillion). In the 2017 budget plan, the ratio of village funds to transfers to the regions is set at 7.9 percent (Rp 60 trillion). It is important to note that as a result of this village law, the number of official villages has increased from 74,093 in 2015 to 74,754 in 2016. Unless there is a moratorium, the number of village is expected to increase by around 1,800 in the upcoming years.[17] By law, every village is entitled to receive around Rp 1 billion (US$ 75.2 thousand) per year. Clearly this trend will lead to significant pressure for the state budget in the future.

[17] http://finansial.bisnis.com/read/20160421/10/540100/amankan-dana-desa-kemenkeu-usulkan-moratorium-pemekaran-desa. Retrieved: 9 September 2016

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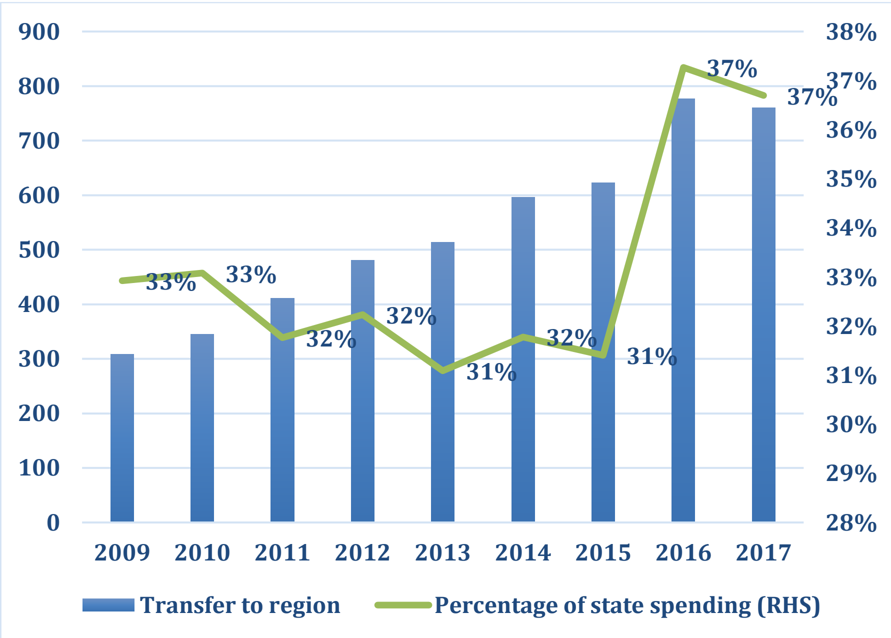
The increase in the transfers to villages is aimed at reducing inter-regional income disparity. However, Indonesia's experiences with fiscal decentralization have produced some undesireble outcomes, including widespread splitting of provinces and districts and an increase in idle funds.[18]To have a better chance of being successful, the programme should naturally be complemented with capacity building at the local level, so that village heads and local institutions learn to better use the fund. In addition, given higher public resources being transferred to local governments and village leaders, robust monitoring and evaluation mechanisms are critically needed. For this, active participation from local stakeholders should be encouraged to ensure that public funds are appropriately used, well-targeted and accountable.

Figure 3: Transfers to Regions, 2004-2017 (Rp trillion)



Source: Ministry of Finance. Author's calculation.

CONCLUDING REMARKS

The 2017 budget clearly reflects the consolidation effort that has been put in to make it realistic and credible, given the continuing global uncertainties and given the sluggish domestic economic performance. Overall, the budget remains expansionary given that the government wants to achieve a growth rate of 5.3 percent. Next year, fiscal spending will still be focused on infrastructure, health, education, and social assistance programmes. This

[18] Fadliya and Ross McLeod, 2010, "Fiscal Transfers to Regional Governments in Indonesia", ANU Working Papers in Trade and Development, No.2010/14.

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is to boost domestic investment and consumption in order to to compensate for lower exports earnings.

The 2017 budget also shows the government's commitment to further implement fiscal decentralization in the form of significant transfers to the villages, as mandated by the village law. Given weak local capacity, it remains to be seen whether increases in village funds will have real positive impact on rural development.

Indonesia's fiscal law limits the deficit of the central government to three percent of GDP and the public debt to 60 percent of GDP. Given these legal limits, Indonesia still has ample room in which to increase its public debt level, which currently is at 27.5 percent of GDP[19], for financing priority programmes. Nevertheless, increasing public debt for development purposes should always be managed prudently for the sake of fiscal sustainability.

Going forward, government spending will be reined in under ongoing fiscal pressure. The knock-on effects of fiscal tightening may affect some infrastructure projects and social assistance programmes. The impact of the tax amnesty programme in the short term will be negligible. For tax receipts to contribute meaningfully to the state coffers, an overhaul of the tax administration system is needed, with particular focus on strengthening the powers and reach of the tax office. This will need strong political will and persistence. On this front, there are great expectations that Finance Minister Sri Mulyani will manage the needed reform of the entire tax administration system.

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[19] IMF, Indonesia Country Report, No. 16/81, March 2016.