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Fiscal Policy Evolution and Distributional Implications: The Indonesian experience

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Abstract

This paper analyses Indonesia's resource mobilisation and public expenditure policies against the backdrop of her inequality trends and macroeconomic policy evolution. It is argued that the country's fiscal policy stance has been adversely impacted by her monetary and financial sector policies under an open capital account, with attendant regressive distributional implications. Juxtaposing the analysis of revenue mobilisation trends and taxation policies with the evidence of increasing asset and land concentration and persisting high inequalities reveals that the increase in income tax revenue did not necessarily come from the upper income profiles or corporate profits. Meanwhile, although government expenditure to GDP ratio has improved after 2003, capital expenditures and social expenditures other than those in education continue to remain low. Further, the current pattern of fiscal decentralisation does not seem to be effective in addressing the existing disparities.

JEL Classification
H 200; H 500; H 700

Key Words
Indonesia, fiscal policy, public finance, inequality, taxation, revenue, government expenditure, financial liberalisation, IMF debt conditionalities, decentralisation

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Fiscal Policy Evolution and Distributional Implications: The Indonesian experience

Smitha Francis*

I. Introduction

Indonesia, the world's largest archipelago-state and the fourth most populous, is a unitary country comprising central, provincial and local levels of government. Under the first president Sukarno (1950-65) and under the thirty year autocratic rule of President Suharto that followed (1968-98), economic rehabilitation and development were pursued as primary goals through a highly centralised administrative structure dominated by the military. But having completed historic elections in 1998 and 2004, Indonesia is presently considered as managing one of modern history's effective transitions from autocratic rule to democracy, and is generally credited with some success in achieving fiscal decentralisation. With timely expansionary policies undertaken by the government, this lower middle income economy has also survived the 2007-08 global economic crisis and the subsequent slowdown relatively well so far. However, the country's development challenges remain daunting.

While the level of extreme poverty (i.e., below the US$ 1.25-a-day poverty line) in Indonesia declined significantly—from about 72 per cent in 1981 to about 21 per cent in 2005 (which was lower than that of the Philippines or Vietnam), the proportion of its population living below the US$ 2-a-day poverty line (49 per cent) was higher than in the above countries in 2005 (ADB, ILO and IDB, 2010). The pace of poverty reduction based on the government poverty line too has been much lower than that before the 1997 crisis.[1] At 14.2 per cent in 2009, official poverty incidence was significantly higher than the target of 8.2 per cent set in the government's Medium-Term National Development Plan 2004-2009. It was also nearly double the Millennium Development Goal (MDGs) target of 7.6 percent in 2015.

When it comes to income inequality based on standard Gini coefficient, Indonesia compares favourably with the other Southeast Asian countries and does not show significant variation over a relatively long period of time. During 1981-2008, the Gini coefficient of per capita income hovered around 0.32–0.37 (ADB, ILO and IDB, 2010). Mishra (2009) showed that not only overall inequality, but inter-provincial distribution of consumption also showed very little variation. Indeed, mainstream academic literature on Indonesia has often indicated that income inequality in the country has been relatively low as a consequence of the "pro-poor growth" policies adopted by the governments (e.g. Ragayah 2005; Timmer 2004, 2005; and World Bank 2005 quoted in Leigh and Eng, 2007).

However, as several other analysts have pointed out, inequality would be expected to be significant in the country given the diversity of Indonesian provinces in terms of geography, natural resource endowments,[2] population density, levels of urbanisation[3] and industrial development, and due to the fact that Indonesia has never undertaken any land redistribution programme. Further, changes in inequality trends would be expected given that Indonesia has undergone a series of financial and economic shocks, natural disasters and at least two major changes in its entire system of government (Mishra, 2009). Such contrasting views are in part caused by the significant difficulties in interpreting the available income and household consumption expenditure survey data for Indonesia from the National Socio-Economic Survey (Susenas) (Suryadarma et al, 2006; Sakamoto, 2007; Leigh and Eng, 2007; Mishra, 2009; Akita and Pirmansah, 2011).[4]

Several studies have shown that despite the overall impressive economic performance and the ambitious decentralisation programme, the impact of economic growth and more critically of public service provision has not been shared equally across the Indonesian provinces. The significant disparities in access to public services are evident when we analyse the evidence on provincial per capita GDP and social indicators, including the provincial Human Development Index (HDI). Sakamoto (2007) has shown that the inter-provincial income distribution differs greatly between when oil and gas income is included in the GDP figures and when it is not, and provides evidence of increasing regional disparity. Incomes have tended to be relatively high in Jakarta, Riau, East Kalimantan, and other mineral rich provinces. But except for Jakarta, the population in these provinces is generally small and has not grown very rapidly, and this in turn has implications for inter-provincial income distribution. The national and provincial HDI values confirm that although Papua was the third richest province in terms of regional per capita income, it was among the most disadvantaged Indonesian provinces, ranking 29 out of 30 on the human development scale. In

general, people of the western region are better-off than those in the eastern regions, with those in Papua remaining as the least developed group (Bappenas, 2010b; Mishra, 2009; etc). Further, significant differences in HDI scores existed across districts within each province.

Suryadarma et al (2006) analysed the difference in access to: education and health facilities; education and health outcomes; voice and political participation; and income and consumption, between people based on region of residence and ethnicity. They found that the highest level of disparity persists between urban and rural areas in every indicator considered.[5] Similarly, Akita and Pirmansah (2011) have shown that the positive economic growth rates since 2004 have been associated with rising urban inequality. This, according to them, together with a widening urban-rural disparity, contributed to an increase in overall inequality in per capita household expenditure in the recent years.

Against this backdrop, this paper is an attempt to analyse the role played by fiscal policy in the inequality patterns observed in Indonesia, by examining government resource mobilisation strategies and expenditure policies in detail. Section II sets the overall context of the study by reviewing Indonesia's economic growth experience and the evolution of its macroeconomic policies briefly. Section III examines the country's fiscal stance over the recent decades. Section IV analyses the evolution of Indonesia's revenue structure and revenue mobilisation policies as influenced by the country's fiscal policy stance over the years. This includes a discussion on the changes in the resource mobilisation efforts of sub-national governments under decentralisation. Section V examines the impact of the changes in revenue mobilisation pattern at the central and sub-national levels on trends and patterns in government expenditure and their implications. Section VI summarises the main findings of the study and includes some policy suggestions.

II: Macroeconomic Background and Growth Performance

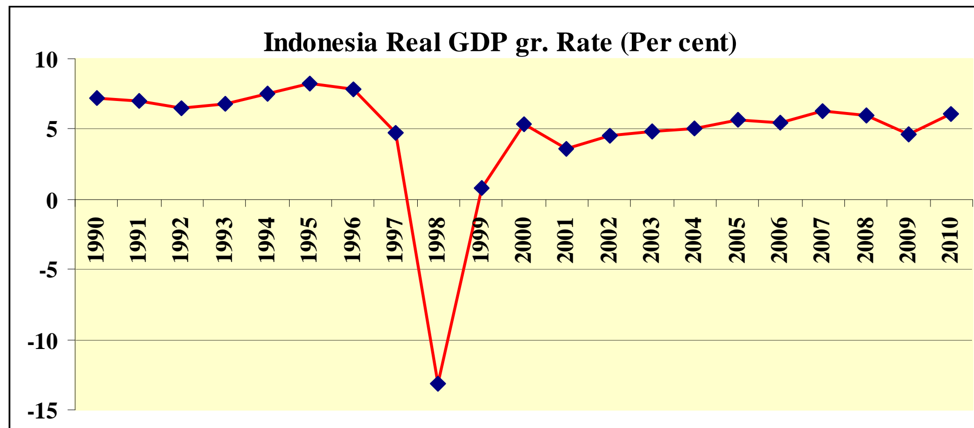
During the three decade period of the highly centralised 'New Order' regime under President Suharto beginning in 1968, the improvements in the economy's infrastructure (especially in transport, communications, power and irrigation), the close strategic relationship with the US and an open capital account[6] led to a substantial rise in foreign aid and investment into Indonesia. Lured in by tax incentives, foreign investments went primarily into labour-intensive import-substitution manufacturing as well as into resource-intensive

industries such as oil, minerals and lumber that aided in the rapid growth of extractive exports. Simultaneously, the oil boom of the 1970s allowed for high levels of domestic capital investments.[7]

But faced with the adverse conditions of the collapse of international oil prices in the early-1980s, the Indonesian government began undertaking deep economic liberalisation policies like its Southeast Asian neighbours. In the Indonesian case, the economic reforms were driven by the need to attract finance capital and foreign aid to help stimulate the country's non-oil exports and to improve the government's fiscal position. Trade and exchange rate policies were liberalised extensively and the currency, Indonesian Rupiah, was devalued in 1983 and 1986.[8]

Favourable external demand conditions enabled the country to enjoy moderate rates of economic growth prior to the 1997 Asian financial crisis. During 1970-96, the annual growth of real GDP averaged 6.7 per cent and inflation averaged 10 per cent. But this growth concealed certain structural weaknesses in the economy related to an open capital account and financial sector liberalisation.

Chart 1: Indonesia's Growth Performance, 1990-2010



Source: IMF

Even though the country had an open capital account since 1970, the banking sector deregulation and stock market reforms carried out between 1983 and 1990 together led to increased systemic risk in the economy,[9] through an increase in the number of aggressive banks in the first half of the 1990s as well as increased cross-ownership and cross-management in the financial sector involving leading Indonesian conglomerates.[10] Meanwhile, to ward off inflation as well as the constant threat of capital outflows

and speculation against the rupiah under the open capital account, real interest rates were kept high after 1983 and averaged 9.5 per cent during 1984-1997 (Pincus and Ramli, 2004). But persistently high interest rate gaps between domestic and international lending rates led to heavy reliance on foreign borrowing.[11] Under the fixed exchange rate regime, the large capital inflows led to overvaluation of the Indonesian rupiah and increased the current account deficit, generating significant risk of speculative attacks on the currency.[12]

With increased systemic risk and a heavy debt burden, Indonesia became a victim of the contagion effect of Thailand's financial crisis in mid-1997. Following the dramatic reversal of capital flows into the country, the rupiah fell about 18 per cent against the dollar through August 1997 alone (Ramli and Nuryadin, 2009: p. 123). Unable to service its huge public debt following the continuing and drastic depreciation of the rupiah, the government turned to the IMF in October 1997 for an emergency debt package totalling US$ 43 billion. This was to become a deciding factor in the fiscal stance of the government.

Under its first three-year US$ 5 billion loan to Indonesia, the IMF prescribed a strict monetary policy to stabilise the exchange rate and a tight fiscal stance to reduce the fiscal deficit. Even though interest rates were immediately increased in order to stabilise the rupiah, capital outflows continued. Further, as the high interest rates led to a severe liquidity crunch, the economy went into a contraction. When rupiah collapsed further, in a new Letter of Intent issued in January 1998, the IMF secured another set of even more stringent reform commitments than in the first one (Francis, 2003).

Among the liberalisation measures that were part of the conditionalities, trade liberalisation and privatisation of hundreds of state-owned enterprises (SOEs) in particular, impacted government revenue mobilisation levels significantly. At the same time, this second package of IMF reforms not only failed in achieving immediate stabilisation, but the policies of monetary contraction and tax increases also worked to intensify the crisis, thus making the economic situation faced by millions of people in the country worse. As seen in Chart 1 above, Indonesia experienced a negative GDP growth of 13.1 per cent in 1998, the worst in its history. The incidence of absolute poverty had climbed to 23.3 per cent (48 million persons) in 1999 from about 11.3 per cent in 1996. The social unrest unleashed by these extreme economic conditions also led to the conditions for a major political transition involving democratic elections and the introduction of a new constitution.

To achieve economic stability and growth, the Indonesian authorities formulated another economic reform programme in 2000 supported by IMF's financial and technical assistance. The programme envisaged restoring the growth rate to 5-6 per cent over the medium term, restricting inflation to below 5 per cent annually, and achieving fiscal sustainability. Under this programme, public debt—which had shot up from 25 per cent of GDP before the crisis to about 100 per cent of GDP in 2000—was to be reduced to 65 per cent of GDP by 2004. Thus although it was important to maintain fiscal stimulus given the fragility of the emerging recovery in early 2000, the government's medium-term macroeconomic framework targeted a gradual reduction in central government deficit.

Due to the negative impacts of higher interest rates and reduction in government expenditure on employment–generating economic growth, Indonesia was the slowest to recover from the 1997 crisis during the early 2000s. However, its GDP growth has steadily risen since 2004. The strong economic growth was in part due to a sharp increase in exports, particularly in commodities such as palm oil, tin and rubber. In the five years preceding the 2008-09 global financial crisis, the commodity boom led to a 120 per cent increase in exports, which was even stronger than the growth through the 1990s (Goff, 2010). Primary commodities dominate Indonesian exports (50 per cent) (Saparini, 2012). On the other hand, Indonesia's manufacturing base remains narrow, focused on assembly rather than manufacturing. Further, industries such as textiles, garments and footwear have all come under competitive pressure from other Asian low wage economies such as China, Bangladesh and Vietnam (Mishra, 2009; Saparini, 2012).

Even though there was a slowdown in growth to 4.5 per cent in 2009 due to the fall in global demand, Indonesia was still the third-fastest growing country in the G-20 after China and India. According to IMF data, growth rebounded in 2010.

Meanwhile, major democratic reforms together with the moves towards decentralisation and increased regional autonomy have had an important impact on the economy during the 2000s. The country's decentralisation programme began in 2001, and involved unprecedented political autonomy for the regions as well as the transfer of significant functions from the central government. The fiscal decentralisation programme was fundamentally built on two laws: Law 22, which includes a general assignment of functional responsibilities for all levels of government,[13] and Law 25, which provides local governments with a share in central revenues. Local government revenues now include a larger share of natural resource revenues,

general-purpose transfers, and own revenue sources. The salient features of the decentralisation programme and their implications will be discussed in detail in the ensuing sections.

In the next section, we will examine how the macroeconomic situation and the decentralisation process influenced the Indonesian government's fiscal stance and the associated fiscal policy and budgetary reforms.

III: Fiscal Stance and Fiscal Policy Reforms

As we saw, fiscal consolidation was one of the core economic objectives in Indonesia from the late 1990s onwards under the IMF loan conditionalities. The government thus had undertaken sweeping reforms, many of which affected government's revenue mobilisation and public expenditure patterns significantly with attendant implications for employment generation and poverty reduction.

The trends in the revenue and expenditure ratios (total revenue/GDP and expenditure/GDP) presented in Chart 2 reveal that even before the 1997 crisis, Indonesia had followed a conservative fiscal stance. In fact, it had registered fiscal surpluses in 1990 and during 1994-97.

As seen in Table 1, both revenue and expenditure ratios averaged about 17 per cent of GDP during 1990-96 and the country maintained an average fiscal surplus of 0.3 per cent of GDP. Under the impact of the 1997 financial crisis, the fiscal balance deteriorated from 0.6 per cent of GDP in 1997 to -1.7 per cent in 1998.

Table 1: Indonesia's Overall Budget Performance, 1990-2009

(Percentage of GDP)

Budget Aggregates	**1990-96**	**1997-2000**	**2001-04**	**2005-08**	**2009**
Government expenditure	17.0	13.9	18.9	19.4	16.7
Total revenue	17.2	13.3	17.3	18.7	15.1
Fiscal surplus/deficit	**0.3**	**-0.6**	**-1.6**	**-0.7**	**-1.6**
Real GDP growth rate (%)	7.3	-0.6	4.5	5.9	4.6
Interest payments	1.8	2.3	4.0	2.1	1.0
Primary surplus/deficit	**2.1**	**1.7**	**2.4**	**1.4**	**0.1**

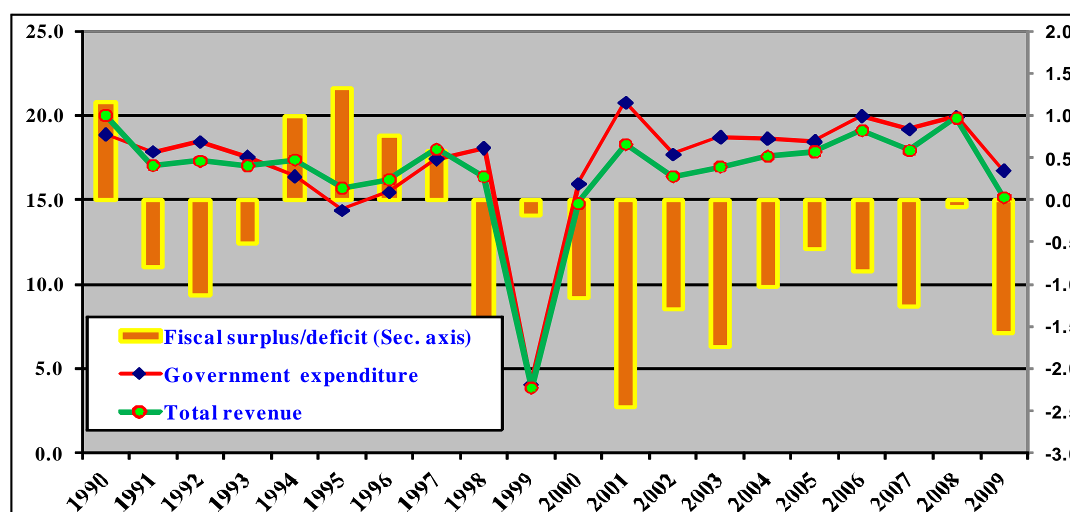
Source: Government Finance Statistics, Bank Indonesia

Subsequently, in 1999, while the revenue ratio fell sharply due to the drastic downturn in economic activity, the expenditure ratio also declined to about 4 per cent (see Chart 2). The latter was because of the government commitment to reduce expenditure soon after the crisis, as a result of which public investment and other development expenditures were reduced drastically.[14] With the simultaneous fall in both revenue and expenditure ratios, fiscal deficit was just 0.2 per cent in that year.

Even though the expenditure ratio increased to about 16 per cent of GDP in 2000, at 1.2 per cent of GDP the fiscal deficit was still not very large.

Chart 2: Revenue and Expenditure Ratios and Fiscal Balance in Indonesia, 1990-2009

(Percentage of GDP)



Source: Government Finance Statistics, Bank Indonesia

Since then, the country has continuously run fiscal deficits. However, what is striking is that except in 2001, fiscal deficit has never risen above 2 per cent of GDP (See Table 1). The slightly bigger fiscal deficit in 2001 (2.5 per cent) was a consequence of the fiscal stimulus undertaken by the government during 2000-2001 in order to maintain a fledgling post-crisis recovery. The expenditure ratio was nearly 21 per cent in this year, the highest the country had seen since 1990. But the strong hold of fiscal conservatism is evident from the fact that fiscal deficit, which had widened from 1.2 per cent to 2.5 per cent of GDP in 2001, fell again to 1.3 per cent in 2002 (well below the deficit target of 2.5 per cent), despite adverse economic and political developments that would have warranted higher levels of government expenditure to support domestic economic recovery and social expenditures.[15]

The earlier trend in conservative fiscal policymaking continued into the fiscal rule adopted by Indonesia in 2003, which caps annual deficits at 3 per cent of GDP and accumulated debt at 60 per cent of GDP.[16]

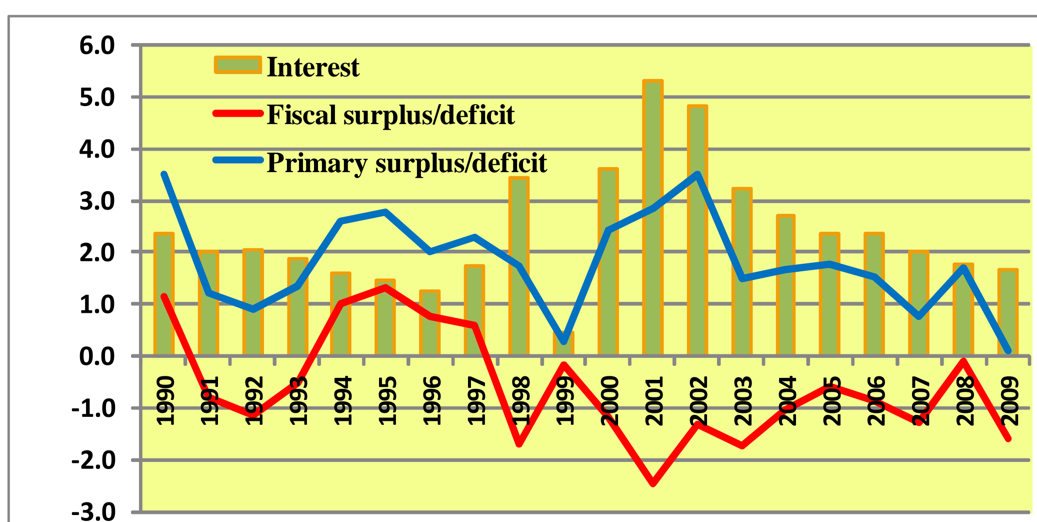
The expenditure ratio has recovered and surpassed the pre-crisis levels since 2003. It peaked at 20 per cent in 2006 before declining slightly again. Due to the fiscal stimulus package undertaken by the government in the aftermath of the global financial crisis and recession, the expenditure ratio touched nearly 20 per cent again in 2008.

The revenue ratio also began recovering from 2004 onwards and peaked at about 20 per cent in 2008, before registering a sharp decline to 15 per cent in 2009. In 2009, at 16.7 per cent of GDP, there was a significant decline in the government expenditure ratio too. Thus during the period 2005-08 also, fiscal deficit was still only 1.6 per cent of GDP, the same as the average for the period 2001-04 (Table 1).

Significantly, even these low levels of fiscal deficit recorded by the country did not reflect an expansionary fiscal stance of the government.

Chart 3: Indonesia's Fiscal Balance, Interest Burden and Primary Balance

(Percentage of GDP)

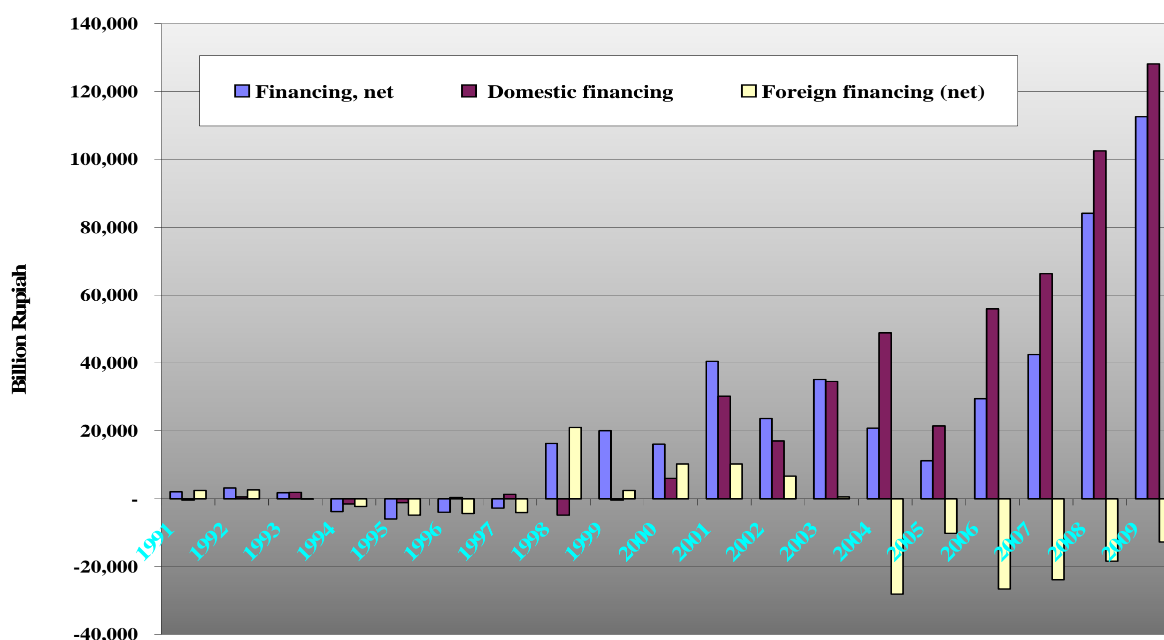


Source: Government Finance Statistics, Bank Indonesia

As we can see clearly in Chart 3 (see also Table1), Indonesia's primary balance (fiscal balance minus interest payments) has been positive throughout the period under consideration. The primary balance reflects the actual fiscal stance of the government given that it represents the government's actual net spending for all activities including capital investments (minus debt servicing) and social expenditures.

While interest payments constituted only about 1.8 per cent of GDP on average during 1990-96, this ratio increased significantly in the post-1997 period to peak at nearly 5 per cent of GDP during 2001-02, before starting to decline. The primary surplus, which was already 2 per cent of GDP during 1990-96, peaked at 3.5 per cent of GDP in 2002, before declining to an average 2 per cent during 2005-08. The primary balance was positive even in 2009. This clearly reveals a severe contractionary bias in the country's fiscal stance.

Chart 4: Composition of Indonesia's Government Financing, 1991-2009

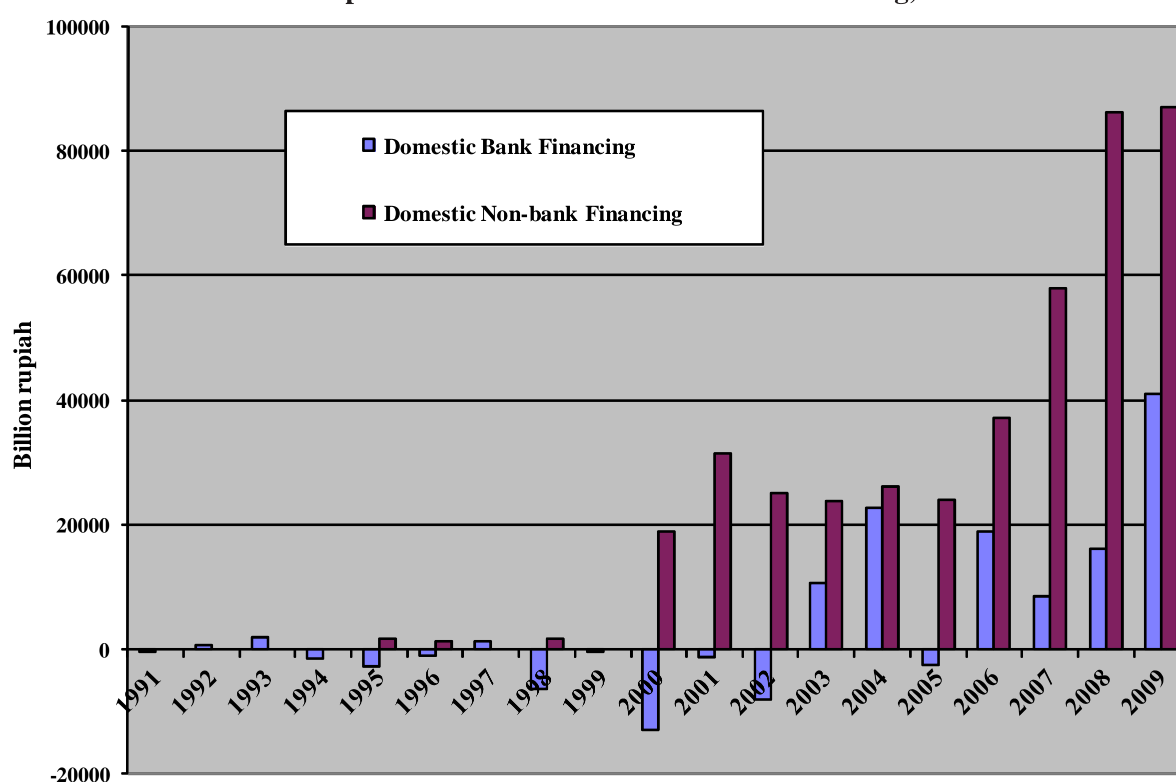


Source: Government Finance Statistics, Bank Indonesia

Chart 4 illustrates the changing composition of Indonesia's budget financing in terms of domestic and foreign borrowing. Indonesia's domestic public debt was not very high before the 1997 crisis. Out of the total debt burden of US$ 136 billion, public sector debt was US$ 54 billion, while private foreign debt was US$ 82 billion. But by 2001, the government's foreign debt had risen to US$ 74 billion, in addition it had borrowed Rp 647 trillion from the domestic private sector (Ramli and Nuryadin, 2009: p. 129).

The large increase in public debt from 2001 onwards did not reflect expansionary fiscal policies, but the use of bonds to finance bank recapitalisation (estimated at about Rp 600 trillion) in the post-1997 crisis period (see Charts 5 and 6). Even though most of these bank assets were subsequently sold (at bargain prices), the government had to shoulder the burden of interest payments on the debt incurred for their recapitalisation. Simultaneously, in accordance with the IMF recommendation, the government also had to take over a significant portion of private sector assets via debt restructuring (including Rp 144 trillion debt incurred by the private sector from Bank Indonesia Liquidity Credits (BLBI)), thereby imposing a massive burden on the government budget (Rosser, 2004; Francis, 2003; Ramli and Nuryadin, 2009).

Chart 5: Composition of Indonesia's Domestic Financing, 1991-2009



Source: Government Finance Statistics, Bank Indonesia

Indonesia's public debt was also related to the "borrowing" from the IMF in 2001 to "support" its balance of payments. The US$ 400 million pledged by the IMF was to be used only if Indonesia experienced a BoP crisis and ran out of international reserves (which stood at USD 28 billion at the time). Even though Indonesia could not actually use the IMF loans, they had to pay interest on them. In 2001, for instance,

Indonesia received IMF loans worth US$ 400 million and paid US$ 2.3 billion to the IMF in terms of principal and interest payments (Ramli and Nuryadin, 2009: p.132).

The size of the domestic debt was also closely connected to Bank Indonesia's monetary policy, which at the time followed the IMF advice to control inflation through tight monetary policy and high interest rates on Bank Indonesia Certificates (SBIs). Every one per cent increase in the SBI rate would lead to an increase in the government deficit of Rp 2.3 trillion (Ramli and Nuryadin, 2009: p. 130). Ironically, inflation was not a monetary problem during this phase; rather it was caused by the rise in government-administered prices brought about by IMF conditionality. The government had to increase the price of kerosene by 25 per cent and that of gasoline by 71 per cent in May 1998, in order to reduce fuel subsidies.[17]

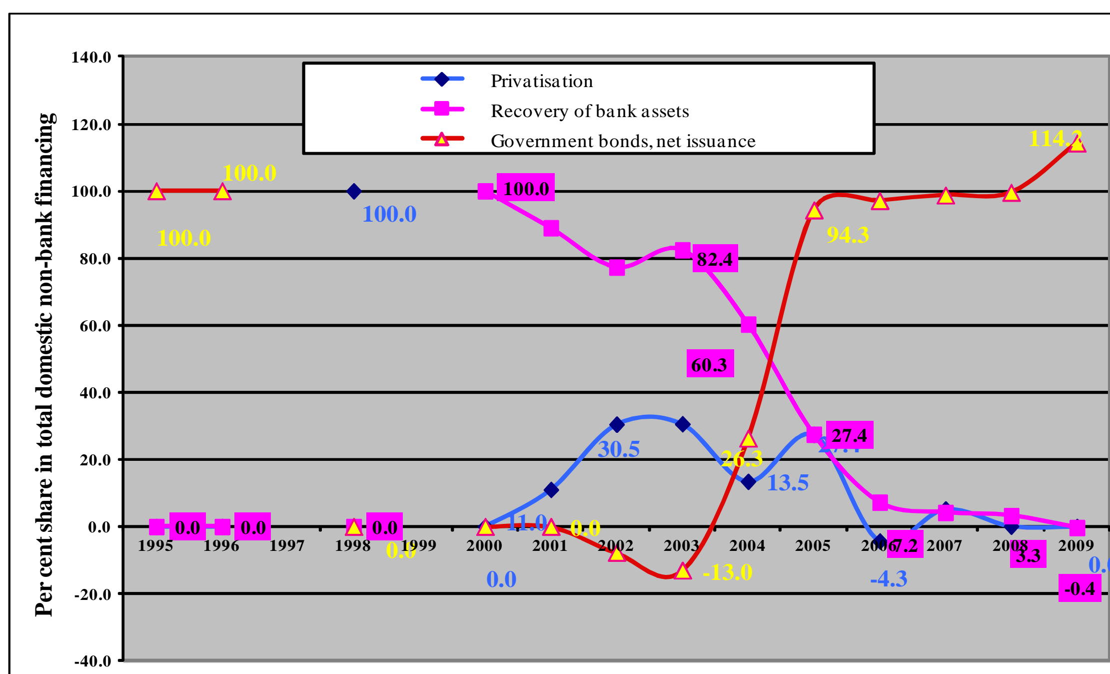
Higher interest rates and reduction in public spending led to higher unemployment and a sharp increase in poverty in the post-crisis period, as we saw in the first section. It should be noted that high interest rates are particularly bad for small producers and those who already have less access to finance (such as those with few assets and women). The lowest income groups in the society would be the worst affected also due to the increase in the prices of essential services like fuel, electricity, etc. resulting from the reduction in subsidies. All these processes would clearly lead to an increase in inequality. Indeed, Leigh and Eng (2007), who estimated top income shares for Indonesia during 1920–2004 using taxation and household survey data, observed a sharp rise in top income shares during the late-1990s, pointing to a worsening of income inequality in the post-crisis period. As we saw in the earlier section, expenditure-GDP ratio had fallen during this phase.

It is clear that Indonesia's fiscal policy stance during these years was significantly determined by its monetary and financial sector policies and its interest burden due to the IMF loan. Thus while the orthodox policy prescription is that fiscal consolidation is the key to achieving financial and macroeconomic stability,[18] it can be seen that maintenance of financial stability – that cannot be achieved under policies of unfettered financial liberalisation and open capital accounts – is key to implementing fiscal policy from an equity point of view.

When it comes to resource mobilisation, privatisation played a significant role during 2000-2005 as revealed in Chart 6. Clearly, sale of public assets bring in only once-for-all resource inflows for financing expenditures and they lead to a reduction in government revenues in the medium and long-term.

Further, as this is a capital account transaction, the sale of public assets needs to be counterposed against other capital account items like public debt. Therefore, the loss of revenue from those assets has to be compared with the interest payment on new debt to understand if privatisation was successful in revenue mobilisation. At the same time, it should be noted that if the sale of public assets leads to higher user charges for utilities, etc., there will be wider adverse distributional implications.

Chart 6: Composition of Indonesia's Domestic Non-bank Financing, 1991-2009



Source: Government Finance Statistics, Bank Indonesia

Indonesia's debt levels have continued to decline and reached 35 per cent of GDP in 2008. However, as will be discussed in detail in the section on expenditure trends, a key component of the fiscal adjustment programme has been rationalisation of spending.

Further, the fiscal rule adopted in 2003 appears to have engraved fiscal conservatism into the country's macroeconomic policy framework even deeper than before. Thus even though Indonesia announced a stimulus package in late January 2009 – worth 1.5 per cent of GDP in increased expenditure earmarked for infrastructure and other projects in order to generate employment, this package would see the government's projected budget deficit go up from 1 per cent of GDP to only 2.5 per cent.

Meanwhile, the legal framework for budgeting was reformed along with the significant fiscal decentralisation steps carried out from the late 1990s onwards. A series of fiscal and budgetary laws were put in place in the early 2000s.

Among these, the Regional Governance Law (2004) outlines the responsibility of regional governments for a range of public services such as education, health, public infrastructure, agriculture, industry and trade, investment, the environment, land, labour, and transport. Local governments have also assumed major new expenditure responsibilities. Kabupaten and kota[19] essentially are responsible for all public services that the central and provincial governments are not explicitly charged with delivering (Blondal et al, 2009).

Another major transformation on the budgetary side was to have a unified and more comprehensive budget. Previously, there were separate routine (operating) and development (capital) budgets and significant off-budget activity. Efforts in this area took several different forms, which will be discussed in detail in the expenditure section.

With oil production projected to decline, increasing the buoyancy of non-oil and gas tax revenue has been the other key element in Indonesia's fiscal adjustment strategy. This was aimed at reducing budgetary dependence on erratic and falling oil revenues. There were three key elements in the revenue mobilisation policies.

Low compliance and poor administration of the individual income tax have been continuing problems in Indonesia. Given that low compliance was believed to have been caused to a large extent by high marginal tax rates and low personal exemptions, tax policy reforms were carried out by decreasing the tax rate, increasing income thresholds and reducing exemptions.

But with the economy slowly recovering from a major economic and financial crisis, the authorities did not want to rely exclusively or primarily on tax changes for increasing the tax yield. They sought to generate as much revenue as possible through improvements in tax administration. Tax administration reform included improvement in the Directorate General of Taxes' (DGT) organisation, human resources development, online payment, and code of conduct (Ministry of Finance, 2008).

IV: Changes in Government's Revenue Structure and Policies

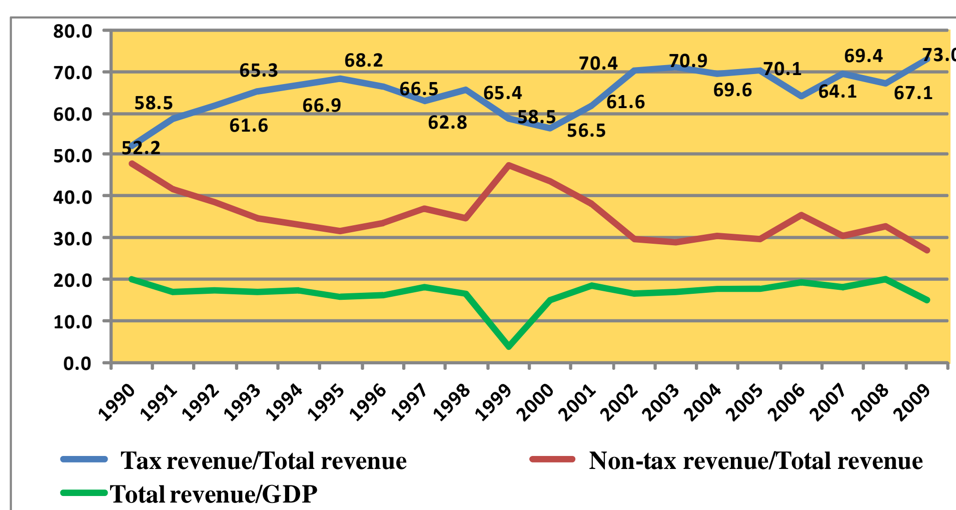
We saw that the revenue/GDP ratio, which was 17 per cent during 1990-96, began recovering from 2004 onwards and peaked at about 20 per cent in 2008. In this section, we will discuss the evolution of Indonesia's revenue structure and the changes in its revenue mobilisation policies as influenced by its fiscal policy stance. These in turn have implications for income inequalities as well as for government's current and future fiscal manoeuvrability.

In Indonesia, domestic revenue mobilisation dominated government's total revenues, with grants contributing only a miniscule share of the total. Within domestic revenues, the shares of tax and non-tax revenues were comparable in 1990, at 52 per cent and 48 per cent of the total respectively. But subsequently, the role of tax revenue in financing the budget has increased significantly. On the other hand, except during 1997-2000, the share of non-tax revenue has shown a steady decline to about 27 per cent in 2009 (Chart 7).

The share of tax revenue has increased steadily except during 1999-2000 when tax revenues declined in the aftermath of the 1997 financial crisis and economic slowdown. Subsequently, the tax revenue share rose again and averaged 70 per cent of the total revenues during 2002-05. Despite a decline during 2006-08, tax revenue share climbed back to account for 73 per cent of total government revenues in 2009.

Chart 7: Composition of Indonesia's Total Revenue, 1990-2009

(Percentage)



Source: Government Finance Statistics, Bank Indonesia

Within total tax revenue, the share of domestic taxes, which constituted as much as 91 per cent of the total in 1990, increased consistently to 97 per cent in 2009 (Table 2). On the other hand, with trade liberalisation, the share of international trade (import and export) taxes, which constituted 9 per cent of total tax revenue in 1990, declined steadily and stood at 3 per cent in 2009.

Table 2: Trend in the Composition of Tax Revenues, 1990-2009

(Percentage share in total tax revenue)

Composition	1990-96	1997-2001	2002-05	2006-08	2009
Domestic taxes	**90.7**	**93.2**	**95.4**	**95.7**	**97.0**
Income tax	41.6	48.5	47.3	49.8	51.2
i. Non-oil and Gas income tax	41.6	42.8	38.7	39.4	43.2
ii. Oil and gas income tax	0.0	6.1	9.0	10.9	8.3
Value added tax	36.9	32.0	32.2	31.1	31.1
Land and building tax	3.8	3.3	3.9	4.6	3.9
Duties on land and building transfers	0.0	0.4	0.9	0.9	1.0
Excise duties	7.5	8.3	10.5	8.7	9.1
Other domestic taxes	0.9	0.7	0.7	0.5	0.5
International trade taxes	**9.3**	**6.8**	**4.6**	**4.3**	**3.0**
Import tax	9.2	5.7	4.5	3.3	2.9
Export tax	0.2	1.1	0.1	1.1	0.1

Source: Government Finance Statistics, Bank Indonesia

While trade taxes were constituted mostly by import taxes, the share of import taxes has declined steadily from nearly 13 per cent of total revenue in 1990 to less than 3 per cent in 2009. Indonesia had significantly reduced its applied tariffs since 1994 in the first phase of the ASEAN Free Trade Agreement (AFTA), with the lowering of rates going well beyond Indonesia's WTO commitments. However, trade liberalisation in agriculture as well as in forestry had lagged behind that of the rest of the economy until 1997. But all trade was significantly deregulated further in late 1997 and early 1998 as part of the IMF conditionalities. In 1998, tariffs on food items were reduced to a maximum of 5 per cent, and applied MFN tariffs in manufacturing were further lowered to a simple average of 9.7 per cent.

The impact of this trade liberalisation was reflected in the fall in the revenue share of import tax from 9 per cent during 1990-96 to 6 per cent during 1997-2000. With progressive trade liberalisation under AFTA

and various bilateral and regional free trade agreements (FTAs) signed by Indonesia during the 2000s, the share of import taxes in total tax revenue has continued to decline and stood at 3 per cent in 2009.

The overall role of export taxes in revenue mobilisation has not been very significant. The increase in the share of export taxes in tax revenue during 1997-2001 can be explained by the fact that the government had converted export bans on some agricultural products into export taxes in September 1998.[20] But export tax rates were to be reduced to a maximum of 10 per cent by 2000. Further, ad valorem export taxes that were imposed to promote downstream processing and higher valued products were also rationalised. The coverage of export taxes was reduced from 12 to four commodity groups (rattan, wood, mineral sands, and palm oil) and rates previously ranging from 10 per cent to 40 per cent were reduced drastically to 1 per cent, 3 per cent, and 15 per cent.

Apart from the impact on revenue mobilisation, such rationalisation in export taxes could have led to an adverse impact on the domestic manufacturing sector. For example, crude palm oil (CPO), which is one of the main export commodities of Indonesia, is also an essential raw material in the production of cooking oil. Thus the objective of the export tax imposed in 2004 was to secure the availability of this raw material domestically, in order to control the price of cooking oil. By creating a wedge in the coordination between fiscal policy tools and industrial and monetary policy objectives, the export tax rationalisation would have had a regressive impact on the lower income groups through the rise in prices of such products domestically.

Overall, the share of value added tax (VAT) declined and the share of land and building tax remained stable at around 4 per cent. Thus the increased tax revenue mobilisation to overcome the reduced role of trade taxes came mainly from income tax. The share of income taxes increased from 42 per cent during 1990-96 to as much as 51 per cent in 2009.

Although a direct break-up of income tax into personal and corporate income tax is not available in Indonesia, estimates based on the mode of collection reveal that the share of personal income tax was lower than that of corporate income tax. According to Nugraha and Lewis (2009), the share of personal income tax (PIT) in total income tax as a mere 19.1 per cent in 2008 compared with the share of corporate income tax (CIT) that constituted 80.9 per cent.[21]

Tax policy reforms are expected to have increased tax compliance to a certain degree. It should be noted that the tax policy changes, which were aimed at providing a higher role for income tax in total tax revenues, sought to reduce the income tax burden of lower-income groups, while increasing compliance. Another goal was to make the Indonesian personal income tax rate as "competitive" as that of other ASEAN countries (Nugraha and Lewis, 2009).

The changes in marginal tax rates presented in Table 3 does reveal that there has been a broadening of the tax brackets, lowering of the marginal rates for the lower income levels, and an increase in the marginal rates for the higher income brackets in the post-1994 period.

Table 3: Changes in Statutory Marginal Tax Rates by Income Group

Income tax law no. 8/1983		Income tax law no. 10/1994		Income tax law no. 17/2000	
Income group	**MTR**	**Income group**	**MTR**	**Income group**	**MTR**
<=IDR 10 million	15 %	<=IDR 25 million	10 %	<=IDR 25 million	5 %
>IDR 10 million and <=IDR 50 million	25 %	>IDR 25 million and <=IDR 50 million	15 %	>IDR 25 million and <=IDR 50 million	10 %
>IDR 50 million	35 %	>IDR 50 million	30 %	>IDR 50 million and <=IDR 100 million	15 %
				>IDR 100 million and <= IDR 200 million	25 %
				>IDR 200 million	35 %

Source: Based on Yuwono(2009).

By 2000, the marginal tax rate for the highest income group with taxable income higher than rupiah 200 million had increased from 30 percent to 35 percent, while the marginal tax rate decreased for the other income groups. These changes appear to have lessened the burden of personal income tax on the lower income groups.

However, recent policy changes related to corporate income tax appears to be more regressive. Although the CIT also had progressive rates before 2009, the government simplified the CIT rate from a progressive rate to a single rate in that year. It is clear that such a policy change would benefit big enterprises more than small and medium enterprises.

Overall, while the income tax reforms during 2000-2008 on both the personal and corporate income categories may have increased tax receipts, this may not necessarily mean that the increased levels came from people in the upper income profiles or from corporate profits.

Improved tax administration is reported to have played a major role, especially in the field of personal income tax, which is heavily dependent on a small number of taxpayers. According to Nugraha and Lewis (2009), tax administration reform accounted for an increase in tax revenue of 1 per cent of GDP after 2004. While the number of registered taxpayers having the Tax Payer ID Number (NPWP) surged over 10 million in 2008 (Bappenas, RPJMN 2010-2014), given that tax payers with income more than Rp 200 million per year constituted only three per cent of total tax payers (Nugraha and Lewis, 2009), it is likely that the increased personal income tax receipts came from the increase in registered tax payers in the other income categories. Similarly, a broad range of tax incentives for investment can make corporate effective tax "zero" in the first 5-10 years in a variety of specified industries.

Thus it is not clear whether the tax policy reforms have been sufficient to reduce the income inequalities entrenched in the society. This is because the extent of asset and income redistribution was historically very small in Indonesia (Mishra, 2009) and there is evidence that asset and land concentration increased further during the high growth periods.

Using taxation and household survey data, Leigh and Eng (2007) estimated top income shares for Indonesia during 1920-2004 and found that where comparable data are available, top income shares were generally higher in Indonesia than in other countries. Similarly, while information on asset ownership and distribution in the country's most dynamic sectors of manufacturing and mining industries are ambiguous, Mishra (2009) quotes a study by Claessens et al. (1999), which estimated the extent of market capitalisation by top ten families in a number of Asian countries. Market capitalisation by the top ten families accounted for as much as 57.7 per cent of the total in Indonesia compared with 46 percent in Thailand, 24.8 per cent in Malaysia, 18.4 per cent in Taiwan and around 2.4 percent in Japan. According to Mishra (2009), there is little evidence to suggest that the structure of ownership in the prominent industries has changed significantly since the advent of democracy following the 1999 elections. Further, whatever data is available tends to suggest a rising inequality in land ownership also.

On the other hand, at 0.5 per cent, the share of land and building tax remains very low in Indonesia and its average contribution to total revenue has not risen above 4 per cent except during 2006-08. Thus, there seems to be much scope for increasing the land and building tax rate from an equity point of view.

After income tax, the second most important domestic revenue source in Indonesia is the value added tax (VAT). However, its share declined from an average of about 37 per cent during 1990-96 to 31 per cent during 2006-09. The share of the other indirect tax, excise duties, increased from about 8 per cent during 1990-96 to nearly 11 per cent during 2002-05, before declining to 9 per cent in 2009.

Other domestic taxes include luxury sales tax, which in principle, has been "non-discriminatory" since 2000 (in the sense of being applied uniformly across the relevant goods). However, some discriminatory elements remained, such as lower sales taxes on Indonesian-made kretek cigarettes and exemption for domestic cars, etc., which were again attempts to utilise taxation policy to meet certain industrial policy objectives. But the luxury tax exemption for domestic cars had to be eliminated after a WTO dispute in 1998. Other luxury taxes were also lowered in early 2003. Currently, luxury sales tax rates range between 10 per cent and 75 per cent on selected products. However, the share of luxury tax in total revenue is abysmally low and has declined in the recent period.

VAT was introduced in Indonesia in 1985. The current VAT rate in Indonesia is 10 per cent. However, exports of goods and services are exempted from VAT. Additionally the following are exempted.[22]

Non-taxable goods (VAT):

1. Mining or drilling products
2. Basic commodities such as rise, corn, salt, sago and soy beans
3. Food and drink served in hotels, restaurants and the like, and that delivered by caterers
4. Money, gold bar and securities

Non-taxable services:

1. Health services;
2. Social services such as orphanages, funeral services, etc.
3. Mail services using stamps
4. Financial and insurance services
5. Religious services
6. Educational services
7. Art and entertainment services
8. Non-advertising broadcasting services
9. Land and water-based public transportation and international air transport
10. Manpower services
11. Hotel services
12. Public services provided by the government
13. Parking area services
14. Public telephone services using coins
15. Remittance services by money orders
16. Food and catering services

With a large number of VAT exemptions on VAT consumed by the lower income groups and strategic sectors, it appears that the Indonesian VAT system may be relatively progressive when compared to other countries with fewer exemptions. However, there is some evidence to suggest that given the level of income concentration in the country in particular sectors, some of these exemptions might be more beneficial or at least equally beneficial to the highest income groups.

For example, exploring the determinants of urban inequality in Indonesia using monthly household consumption expenditure data for 1999, 2002, and 2005 from the National Socio-Economic Survey (Susenas), and focussing on education as a determining factor in inequality, Akita and Pirmansah (2011) have shown that while in urban areas, the richest 10 per cent raised its expenditure share at the expense of the bottom 80 per cent, the changes were more pronounced in the tertiary educational group than in the primary/secondary group. Further, among the richest 10 per cent in the tertiary educational group, an increasing share of households engaged in the trade/hotel/restaurant and finance sectors. In 2005, 25 per cent and 15 per cent of them were engaged in these two categories respectively, which were much larger than their shares in the tertiary educational group as a whole at 15 per cent and 8 per cent. Thus, it may be inferred that the VAT exemptions on hotel and financial services would have benefited such households. Indeed, Akita and Pirmansah (2011) found that these households in the trade/hotel/restaurant and finance sectors had much higher mean per capita expenditure than those in other sectors in urban areas. Thus it may be important to make qualifications in the progressivity of VAT exemptions in Indonesia based on such disaggregated information on other sectors too.

Overall, as Pramudya (2009) pointed out, the concept and implementation of tax reforms in Indonesia seem to have been adversely affected by the limited vision of “a nation that is sometimes burdened by adherence to the prevalent international-level policy style”, and thus have been more preoccupied with administrative adjustments dominated by normative steps, mainly from the point of view of reducing business costs. The tax policy reforms during the 2000s appear to have lost an opportunity to make a more significant contribution to the reduction of inequalities in the society. Meanwhile, Indonesia continues to face challenges in improving collection practices to optimise the collection of individual taxes, implementing adequate sanctions for violators, pursuing the tax evasion perpetrated transnationally, etc.

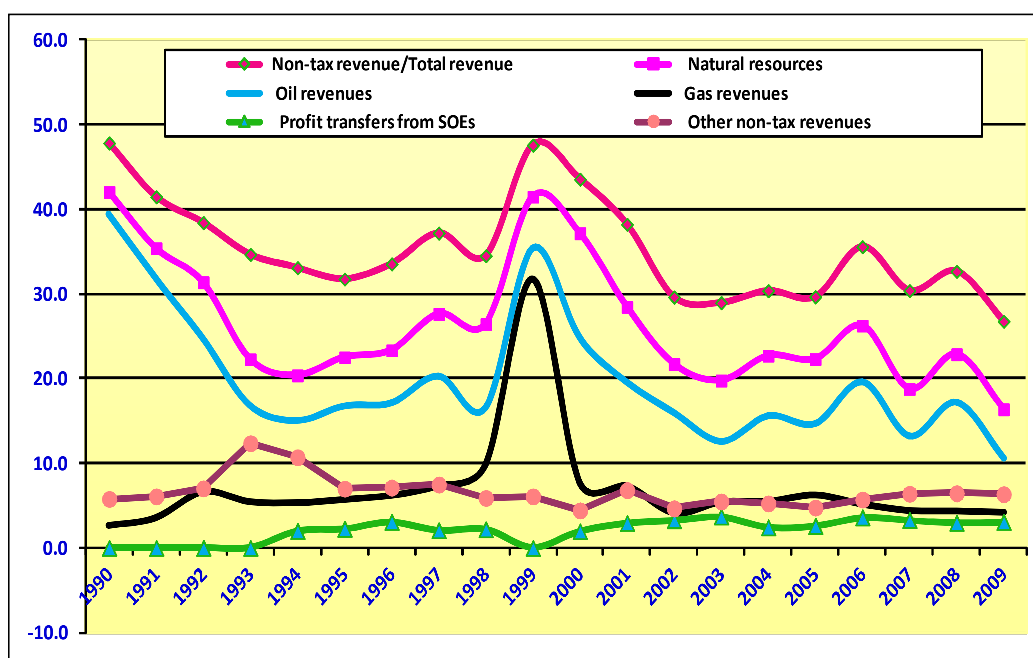
It is pertinent to note that there was another major tax reform undertaken in September 2008 as part of efforts to counter the effects of the global economic crisis. Starting in 2009, the government raised the taxable income threshold for individuals, cut the maximum personal income tax from 35 per cent to 30 per cent, and provided lower marginal personal income tax rates across the four income categories. These were meant to provide some relief to the tax-paying households.

On the other hand, corporate income tax rates were reduced from 30 per cent to 28 per cent in 2009 and to 25 per cent in 2010, and there have been some additional reductions for small and medium enterprises and publicly listed companies. Taxes on dividends were also reduced from a maximum of 20 per cent to a maximum of 10 per cent. However, short-term and long-term capital gains continue to be taxed at the same rate. Clearly, this is not an advisable policy stance from the point of encouraging long-term productive investments into the country.

In the case of non-tax revenue mobilisation (Chart 9), it becomes evident that the declining trend in the share of non-tax revenue in total revenue was accounted for solely by the drop in the share of natural resource revenue. In particular, this was due to the sharp fall in the revenue share of the oil sector (from below 40 per cent of total revenue in 1990 to just 11 per cent in 2009 despite the increase in oil prices), because of the fall in domestic oil production. As Indonesia's oil production concentrated in Northern Sumatra has stagnated and it has very few sources of proven new reserves, its oil production volume has steadily declined over the past ten years – by 40 per cent in total.

Chart 9: Trends in Non-tax Revenue Mobilisation, 1990-2009

(Components of non-tax revenue as percentage share of total revenue)



Source: Government Finance Statistics, Bank Indonesia

The next significant share of non-tax revenue mobilisation took place under the "other" category, whose break-up is not available. The share of the "other" non-tax revenue category, which had registered a major rise during 1993-96 and dropped significantly during 1997-2000, increased again from 2001 onwards and contributed more than 6 per cent of total revenue in 2009.

The third major category of non-tax revenues was profit transfers from state-owned enterprises (SOEs). However, after reaching a peak of nearly 4 per cent of total revenues in 2003, its share has hovered around the pre-crisis level of 3 per cent. This decline in the share of revenue from SOEs can be related to the significant privatisation that occurred during 2002-05 as seen in the earlier section.

Table 4: Composition of Non-Tax Revenues, 1990-2009

(Percentage share in total revenue)

	1990-96	1997-2001	2002-05	2006-08	2009
Non-tax Revenue	37.3	40.2	29.7	32.9	26.8
a) Natural resources	**28.2**	**32.2**	**21.6**	**22.6**	**16.4**
Oil revenues	**23.1**	**23.3**	**14.7**	**16.7**	**10.6**
Gas revenues	5.1	12.8	5.3	4.6	4.2
Other natural resources (General mining, forestry, fishery & geothermal)	0.0	1.0	1.6	1.3	1.6
b) Profit transfers from SOEs	**1.0**	**1.8**	**3.0**	**3.3**	**3.1**
c) Bank Indonesia surplus	0.0	0.0	0.0	0.6	0.0
d) Revenue from Public Service Institution	0.0	0.0	0.0	0.1	1.0
e) Other non-tax revenues	**8.0**	**6.1**	**5.0**	**6.2**	**6.3**

Source: Government Finance Statistics, Bank Indonesia

Resource Mobilisation of Sub-national Governments

Prior to the implementation of fiscal decentralisation, inter-governmental transfers comprised a limited amount of revenue sharing as well as significant routine and development grants.

Shared property taxes accounted for most of total revenue sharing, although shared forestry revenues (forestry licensing fees and royalties) were also occasionally important over the years. Other national revenues, for example, from mining (land rents and royalties) and/or from clove and copra (cesses) were

also at times shared with regional governments, but not consistently, and the amounts were relatively insignificant (Bambang, 2004). On the other hand, development grants over the three decades until 2000 comprised a vast array of general- and special-purpose transfers.

This system of intergovernmental transfers has been significantly restructured and expanded as part of the new decentralisation initiative. Further, two new inter-governmental grants have been created: *Dana Alokasi Umum* (DAU—General Purpose Fund) and *Dana Alokasi Khusus* (DAK—Specific Purpose Fund). Currently, the regional transfer arrangements consist of three key elements:

- revenue sharing;
- general allocation grants;
- specific allocation grants.

Table 5: Composition of Indonesia's Regional Budget Expenditure, 1990-2011

(Percentage of regional budget expenditure)

	1990-96	1997-2000	2001-2004	2005-08	2009	2010	2011
Revenue sharing funds	10.9	12.0	26.1	28.5	24.7	26.0	21.7
General allocation funds	89.1	88.0	68.0	62.5	60.4	59.1	58.6
Special allocation funds	0.0	0.0	1.7	5.3	8.0	6.1	6.7
Special autonomy funds	0.0	0.0	4.1	2.9	6.9	8.8	13.0

Source: Indonesia Budget Statistics, 2005-11

As seen in Table 5, among transfers from the central government, revenue sharing has increased and has come to account for over one-fourth of all transfers since 2001. On the other hand, the share of general allocation funds has come down. The rising share of special autonomy funds reflects the increased transfers to the provinces of Aceh and Irian Jaya in accordance with the special autonomy arrangements with these provinces.

Revenue sharing funds involve the sharing of property tax, personal income tax and natural resources revenue (oil, gas, forestry and mining) by the national government with the regions. There is a rise in the share of tax contribution to the revenue sharing fund until 2009 (dominated by land and building tax), while the contribution of natural resource revenue from general mining also shows an increase (Table 6).

Table 6: Components of Revenue Sharing Fund, 1990-2011

(Percentage of total revenue share fund)

	2005	2006	2007	2008	2009	2010	2011
Revenue Sharing Fund	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Taxation	**47.0**	**43.5**	**55.6**	**48.3**	**53.0**	**49.7**	**49.4**
a. Income tax	10.8	9.3	12.7	12.7	13.4	14.7	16.0
b. Land and building tax	29.6	29.3	35.9	28.4	30.3	25.7	32.0
c. Duties on land and building transfer	6.6	4.9	7.1	7.2	7.9	8.0	—
d. Excise	—	—	—	—	1.4	1.2	1.4
Natural Resources	**53.0**	**56.5**	**44.4**	**52.0**	**47.0**	**50.3**	**50.6**
a. Oil & Gas	44.8	48.7	34.9	42.2	34.3	39.3	38.2
b. General mining	5.1	5.6	6.7	7.9	9.5	8.7	10.2
c. Forestry	0.3	1.9	2.7	1.8	1.7	2.0	1.7
d. Fishery	0.4	0.3	0.3	0.1	0.1	0.1	0.1
e. Geothermal	—	—	—	—	1.4	0.2	0.4

Source: Indonesia Budget Statistics, 2005-11

The general allocation grants require the transfer of 26 per cent of all central government revenue, after revenue sharing. As we saw in Table 5, the share of general allocation grants in total regional transfers has seen a overall decline.

The general allocation grants have two components. First, grants are distributed on a derivative basis to cover the wages of officials previously employed in deconcentrated units and now transferred to the regions. Second, the grant includes an amount based on a formula that takes into account the difference between a region's fiscal needs (which depends on indicators such as population, human development index and land area) and its fiscal capacity (defined as the sum of own revenues and shared revenues) (Blondal et al, 2009).

Given that the rates of revenue sharing for natural resources vary, with the producing regions receiving a disproportionately higher rate of revenue sharing, general allocation grants are supposed to achieve some fiscal equalisation. But Blondal et al (2009) pointed out that in practice, the grant was overwhelmingly focused on covering salary costs, with only a minor component dedicated to equalisation. Given that this makes the regions heavily reliant on local resources, this kind of decentralisation is likely to increase disparities between resource-rich and resource-poor regions as well as between provinces over the

medium- and long-term.[23] This is all the more true in a scenario of a decline in central government expenditures (as will be seen in the next section).

The third component of transfers, namely, specific allocation grants, are used for meeting the special needs of individual regions and for financing central priorities at the regional level. Its share in regional government expenditures has increased (Table 5). Special needs for regions include funding for natural disasters and other emergencies. However, regions applying to the central government for the grant must provide 10 per cent matching funds from their own resources. This can be problematic given that regional government expenditure responsibilities are now considerable and regional governments have very limited own fiscal resources.

Under decentralisation, regional governments have not been awarded new authority over any major tax bases. Sub-national governments, as a whole, retain the right to levy essentially the same taxes and charges as before the new decentralisation legislation took effect, although the distribution of tax bases across provinces and kabupaten/kota have been restructured to a certain extent.[24]

Provinces have at least some authority over taxes related to motor vehicles, change of title of motor vehicles, fuel, and ground water extraction and use (the latter being formerly under the control of kabupaten/kota). But tariffs over these taxes are set at uniform rates across the country by the central government. By law, provinces must share 30 per cent of the motor vehicle-based taxes and 70 per cent of the fuel and ground water taxes with kabupaten/kota.

Kabupaten/kota (but not provinces) are allowed to create their own taxes through local bylaws, if they satisfy a number of good tax criteria and receive central government approval. As it turns out, both local governments and the centre have very broadly interpreted these criteria. As a result, kabupaten/kota have set about creating new taxes in a rather aggressive fashion. The kabupaten/kota, in turn, must share 10 per cent of their total own-source tax revenues with villages. Both provinces and kabupaten/kota may also collect user charges and fees of various sorts.

Apart from the fact that most taxes remain centrally determined, there are also significant constraints on local government borrowing, including the need for pre-approval from the national government and a

complete ban on foreign borrowing. Regional governments also must submit their budgets and have them approved by the national government, in order to ensure that the fiscal rules are adhered to.

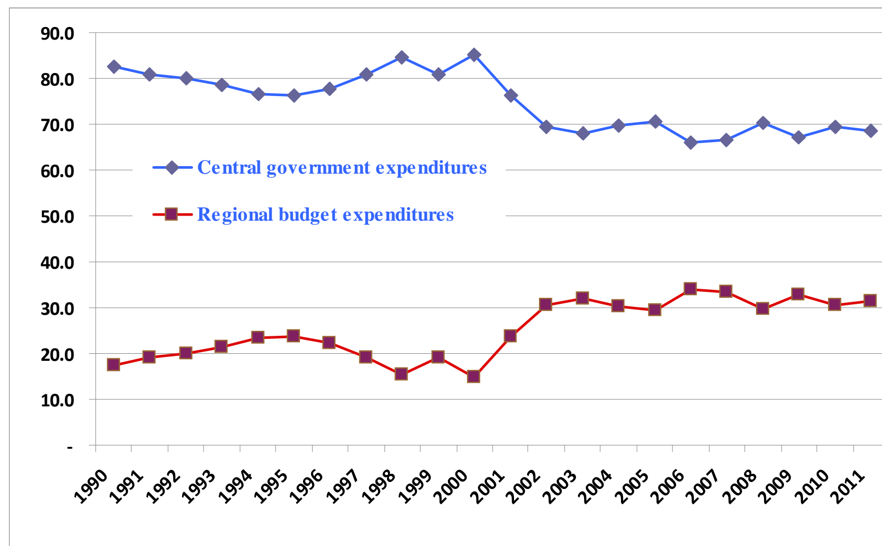
The next section will analyse the impact of these changes in revenue mobilisation pattern at the central and sub-national levels on trends and patterns in expenditure and on human development indicators.

V: Trends and Patterns in Government Expenditure

We saw in Table 1 that government expenditure to GDP ratios, which were relatively low in Indonesia, recovered and surpassed the pre-crisis levels after 2003. A break-up of actual total government expenditures reveals that the share of central government expenditures has shown a decline since 2001 and that of regional budget expenditures has shown an increase, corresponding to the beginning of the decentralisation program.

Chart 10: Trends in Indonesia's Total Government Expenditures, 1990-2011

(Percentage share)



Source: BPS and Indonesia Budget Statistics, 2005-11

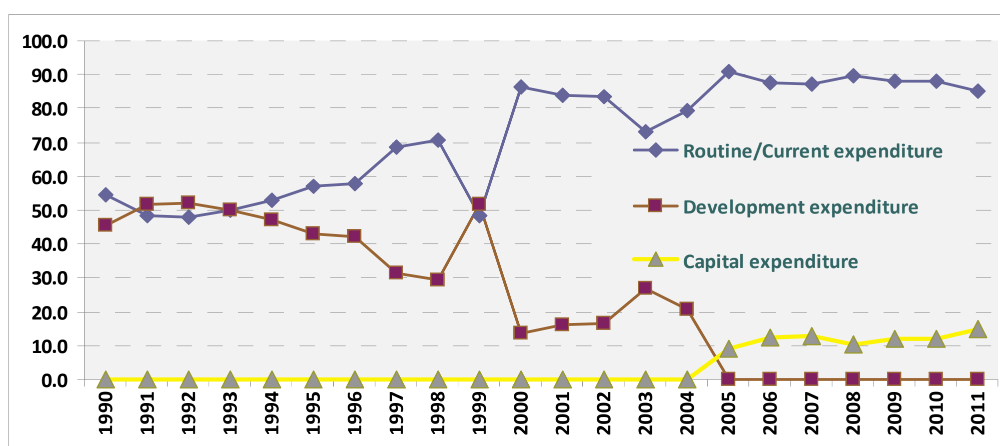
After jumping from 15 per cent in 2000 to 24 per cent in 2001, the average share of regional expenditures has increased to about 32 per cent of the total since 2005.

On the other hand, the share of central government expenditure has declined from as much as 83 per cent in 1990 to about 69 per cent on average during 2010-11. It should be noted that this decline is despite the fact that budgetary reforms since 2005 have seen revolving funds and funds financed by specific earmarked taxes also mostly incorporated into the budget.

Until 2005, Indonesia's central government spending used to be classified under two categories, routine spending and development spending. While routine budgets consisted of expenditures on wage and asset maintenance, development budget comprised of government spending on construction of infrastructure and other capital expenditures. During 1990-94, both routine and development expenditures averaged about 50 per cent of total central government expenditures. But subsequently, despite its direct linkages with present and future level of economic activities and public services, development budget shares declined sharply especially in the post-crisis years and stood at about 21 per cent of total central government budget in 2004.

Chart 11: Composition of Indonesia's Central Government Expenditures, 1990-2011

(Percentage share)



Note: The share of development expenditure drops to zero from 2005 because of the changed classification in that year. From 2005 onwards, it is known as capital expenditure.

Source: BPS and Indonesia Budget Statistics, 2005-11

After the changed classification from 2005, capital expenditure share increased from 9 per cent in 2005 to about 13 per cent in 2006 and stood at 15 per cent in 2011. Clearly, this is quite low for a vast country with

huge regional and provincial inequalities that call for significant public investments for improving infrastructural facilities and public service delivery.

The share of routine/current expenditures, which began rising after 1994 peaked at 91 per cent in 2005 (and 90 per cent in 2008) and averaged about 88 per cent until 2006-2010, before declining to 85 per cent in 2011.

The composition of central government current expenditures shows that before the 1997 crisis (during 1990-96), expenditure on personnel dominated current spending, followed by expenditure on goods and services (Table 7).

Table 7: Composition of Indonesia's Central Government Expenditures, 1990-2011
(As percentage of central government expenditure)

	1990-96	1997-2000	2001-2004	2005-08	2009	2010	2011
Current Expenditure	52.7	68.5	79.9	88.8	87.9	87.8	85.1
Personnel	**23.8**	**18.4**	**17.2**	**16.5**	**20.3**	**20.8**	**21.9**
Goods and services	**8.3**	**7.1**	**5.1**	**9.4**	**12.8**	**14.4**	**16.0**
Interest payment	**13.3**	**18.8**	**29.8**	**16.1**	**14.9**	**13.5**	**14.1**
Domestic interest	0.0	5.6	14.8	10.9	10.1	9.2	9.8
External interest	13.3	13.2	6.6	5.2	4.8	4.3	4.4
Subsidies	**3.7**	**21.1**	**24.3**	**31.8**	**22.0**	**25.8**	**22.4**
Oil subsidies	3.0	15.5	8.7	26.4	15.0	18.4	16.2
Non-oil subsidies	0.6	5.6	3.2	5.4	6.9	7.3	6.2
Social assistance	**0.0**	**0.0**	**3.5**	**8.6**	**11.7**	**9.1**	**7.5**
Other current expenditure	3.7	3.0	0.0	6.3	6.2	4.2	3.2
Development Expenditure	**47.3**	**31.5**	**20.1**	**0.0**	**0.0**	**0.0**	**0.1**
Capital expenditure	**0.0**	**0.0**	**0.0**	**11.2**	**12.1**	**12.2**	**14.8**

Source: BPS and Indonesia Budget Statistics, 2005-11

While the expenditure shares of personnel declined during the crisis (1997-2000) and in the ensuing recovery period, those on goods and services began rising from 2006 onwards. The share of personnel expenditure did not recover to the pre-crisis level despite increasing significantly from 2009 onwards.

On the other hand, the expenditure shares of interest payments and subsidies increased sharply during the period 1997-2000. After jumping from 12 per cent in 1997 to 23 per cent in 1998 in the aftermath of the crisis, the share of interest payments peaked at 39 per cent in 2002 before starting to decline.

It is clear that the large interest payments that the government had to make on its public debt commitments due to the consequences brought on by excessive financial liberalisation and the open capital account, together with the IMF's inability to prescribe counter-cyclical monetary and fiscal policies, involved a significant opportunity cost in terms of the government's reduced ability to undertake necessary public spending for development and investment expenditures and contributed to the adverse distributional implications as discussed in Section 2. It is only from 2005 onwards that the share of interest payments has come down below 20 per cent of total central government expenditures.

The significant role played by subsidies in total expenditures, dominated by fuel subsidies, is equally striking. Fuel subsidies correspond to the transfers from the central government to the state-owned oil company (PERTAMINA) to cover its losses when the domestic price of fuel is kept below international prices (Kuncoro, 2011). As a net oil importer currently, even though the central government revenue increases substantially with rise in international oil prices, it has to spend more on subsidies to avoid an increase in domestic fuel prices. This is reflected in the increase in the average share of subsidies during 1997-2000 and thereafter. In particular, the share of subsidies in central government expenditure peaked at 33 per cent in 2000 and 2005 due to fuel subsidies (See Table 8 also). This played a significant role in keeping prices low and thus helped in supporting the consumption of lower income groups and contributed to the reduction in poverty between 1997-98 and 2005.

However, disaggregated data on subsidies available since 2005 shows that there has been a significant decline in the share of fuel in total subsidies, along with an increase in electricity subsidy (from 2006 onwards). The share of subsidies in total central government expenditure was as high as 40 per cent in 2008 due to an increase in the share of electricity subsidy.

The shift in the composition of subsidies with the increasing share of electricity subsidy and declining share of fuel subsidy during 2006-09 is clearly more in favour of middle and upper income groups than lower income groups. Indeed, UNDP (2007) reported that there was an increase in poverty by nearly

2 percentage points between 2005 and 2006 due to the inflation after the government increased the price of domestic fuel to bring it in line with the rising world oil prices. There was also an increase in the price of rice in 2006.

Following the 2008 global crisis and recession, there has been an increase in the share of non-energy subsidies such as food and fertiliser subsidies, which are more beneficial to lower income groups and the agriculture sector.

Table 8: Composition of Indonesia's Subsidies, 2001-2011

(Percentage of total subsidies)

	2005	2006	2007	2008	2009	2010	2011
A.ENERGY	**86.5**	**88.1**	**77.8**	**81.0**	**68.5**	**71.5**	**72.4**
1. Fuel subsidy	79.2	59.8	55.8	50.5	32.6	44.2	50.2
2. Electricity subsidy	7.3	28.3	22.0	30.5	35.9	27.4	22.2
B. NON-ENERGY	**13.5**	**11.9**	**22.2**	**19.0**	**31.5**	**28.5**	**27.6**
1. Food subsidy	**5.3**	**5.0**	**4.4**	**4.4**	**9.4**	**6.9**	**8.3**
2. Fertiliser subsidy	**2.1**	**2.9**	**4.2**	**5.5**	**13.3**	**9.1**	**8.9**
3. Seed subsidy	0.1	0.1	0.3	0.4	1.2	1.1	0.1
4. Public service obligation	0.8	1.7	0.7	0.6	1.0	0.7	1.0
5. Interest subsidy on credit program	0.1	0.3	0.2	0.3	0.8	1.4	1.4
6. Cooking oil subsidy	0.0	0.0	0.0	0.0	0.0	0.0	0.0
7. Tax subsidy	**5.1**	**1.7**	**11.4**	**7.6**	**5.9**	**9.2**	**8.0**
8. Soybean subsidy	0.0	0.0	0.0	0.1	0.0	0.0	0.0
9. Other subsidy	0.0	0.2	1.0	0.0	0.0	0.0	0.0
TOTAL SUBSIDIES	100.0	100.0	100.0	100.0	100.0	100.0	100.0

Source: Indonesia Budget Statistics, 2005-11

Meanwhile, data for social assistance available from 2001 onwards also shows that its share in total central government expenditure increased from about 2 per cent in that year to as much as 12 per cent in 2009 before declining to about 8 per cent in 2011.

Thus while Indonesia's expenditure-GDP ratios have remained quite low, it does appear that the most recent years have seen some improvement in spending directed towards the lower income groups, which was necessitated to deal with the adverse impact of the global economic slowdown on the economy.

As pointed out in ILO (2010), given that consumption expenditures (private and public) constitute about 67 per cent of Indonesian GDP, the impact of the weakening external demand on Indonesian growth during 2008-09 was relatively less than in its more export-dependent neighbouring countries. The biggest component of the January 2009 stimulus package was also a tax rebate through which the government hoped to prevent massive layoffs by easing the burden on companies.

But the drop in exports still led to widespread job losses in the formal economy, with subcontracted, casual and temporary workers in export-oriented industries such as textiles and leather industries being the hardest hit. Slowing economic growth prompted a steep reduction in the rate of growth of wage employment and a sharp increase in informal employment. According to ILO (2010), the number of workers in informal employment jumped by about 2 million between August 2008 and February 2009 alone, of which men accounted for 660,000 and women 1.36 million. This reversed the trend of a declining share of informal employment of the previous two years. Given that earnings and productivity are likely to be lower among informal workers and that they have little or no social protection, an expansion in informal employment is a matter of serious concern.

At the same time, data on the functional classification of central government expenditure available for the most recent years shows that while general public services constituted the largest share, this shows a decline from 71 per cent in 2005 to 64 per cent in 2011. Encouragingly, the share of economic affairs has increased from less than 7 per cent in 2005 to nearly 12 per cent in 2011.

It should be noted that the stimulus package of 2009 contained spending for infrastructure development, including the improvement of highways, ports, bridges and irrigation systems. The government also significantly increased the budget allocation for poverty alleviation programmes as well as for job training at Vocational Training Centres (BLKs) and training in labour-intensive sectors.

However, among social sectors, only education sector's share of central government expenditure was significant at about 10 per cent. In 2009, it had increased to nearly 14 per cent before declining again to 10 per cent in 2011. Social expenditures other than those in education remain abysmally low. The shares of

housing and community amenities, health, and social protection stood at just 2.8 per cent, 1.6 per cent and 0.5 per cent of central government expenditures respectively in 2011. The highest share recorded for health sector during this period stood at 3 per cent in 2007.

Table 9: Functional Composition of Central Government Expenditure, 2005-11

(Percentage share)

	2005	2006	2007	2008	2009	2010	2011
General public services	70.8	64.4	62.6	77.1	66.4	67.7	63.8
Defence	6.0	5.6	6.1	1.3	2.1	2.7	5.5
Public order and safety	4.3	5.4	5.6	1.0	1.2	2.2	2.4
Economic affairs	6.5	8.7	8.4	7.3	9.4	7.8	11.6
Environmental protection	0.4	0.6	1.0	0.8	1.7	1.1	1.3
Housing and communities amenities	1.2	1.2	1.8	1.8	2.3	2.8	2.8
Health	1.6	2.8	3.2	2.0	2.5	2.5	1.6
Tourism and culture	0.2	0.2	0.4	0.2	0.2	0.2	0.3
Religion	0.4	0.3	0.4	0.1	0.1	0.1	0.2
Education	8.1	10.3	10.1	8.0	13.5	12.4	10.0
Social protection	0.6	0.5	0.5	0.4	0.5	0.5	0.5
T OTAL	100.0	100.0	100.0	100.0	100.0	100.0	100.0

Source: Indonesia Budget Statistics, 2005-11

It should be noted that even though Indonesia scored some early successes in the field of health, the country is still faced with low general public health conditions, which can be seen by the high infant mortality rate (IMR), high mortality of children below 5 years, high maternal mortality rate (MMR) and high percentage of children below 5 with low and bad nutritional status (Bappenas, 2010a). Progress has also been slow with regard to the provision of access to clean water and sanitation.

Similarly, while the country had remarkable success in raising primary education enrolment, there are significant disparities in educational status between different areas, between gender and between people with different social-economic status (UNDP, 2007). Thus, as we also saw in the introduction, despite the overall impressive economic performance and the ambitious decentralisation programme in Indonesia, the impact of economic growth and more critically of public service provision has not been shared widely or equally.

On the other hand, it is seen that while the share of central government expenditure in total national expenditure has declined and that of regional governments has increased, the current pattern of fiscal decentralisation might be contributing to worsening the regional and provincial disparities. This is because studies have shown that the energy-rich regions have benefited greatly from the rise in commodity prices and have amassed significant reserves due to: (a) capacity constraints; (b) problems of too little budget execution or spending; (c) underestimations of own-source revenues and revenue-sharing proceeds; (d) risk aversion (to bank deposits and away from anything else) caused by the government's anticorruption drive; etc. (See Blondal et al, 2009, Subiyantoro, 2010, etc.). Thus given that the regional governments' actual spending has not been rising, the prevailing pattern of revenue sharing might not be adequately supporting the less well-off regions.

VI: Conclusion

It is seen that having maintained an open capital account since 1970, Indonesia's fiscal policy stance has been significantly influenced by her monetary and financial sector policies, which have affected revenue mobilisation and public expenditure patterns with attendant implications for employment generation, poverty reduction, income distribution and the development trajectory. While the country maintained a contractionary fiscal stance even before the 1997 crisis, fiscal consolidation became further entrenched into the policy framework under the IMF loan conditionalities in the late 1990s and later on under the fiscal rule adopted by Indonesia in 2003. This has had important distributional implications.

On the revenue mobilisation front, the role of tax revenue in financing expenditures has increased significantly in Indonesia. The share of non-tax revenue in total revenue has fallen significantly, primarily because of the sharp fall in the share of oil revenue related to the fall in domestic oil production. With the share of VAT declining slightly and the share of land and building tax remaining stable, the increased tax revenue mobilisation to overcome the reduced role of oil revenue and trade taxes occurred mainly from income tax.

Overall, the income tax reforms during 2000-2008 on both the personal and corporate income categories are seen to have led to the increased tax receipts. But this does not necessarily mean that the increased levels came from people in the upper income profiles or from corporate profits given the evidence that asset and land concentration increased during the high growth periods. Improved tax administration is seen

to have played a major role in improving collection, especially in the field of personal income tax. Thus it is not clear whether the tax policy reforms have been sufficient to reduce the income inequalities entrenched in the society.

Again, with a large number of VAT exemptions on goods and services consumed by the lower income groups and on strategic sectors, it appears that the Indonesian VAT system may be relatively progressive when compared to other countries with fewer exemptions. However, there is some evidence to suggest that given the level of income concentration in the country in particular sectors, some of these exemptions might be more beneficial or at least equally beneficial to the highest income groups.

On the expenditure side, although government expenditure to GDP ratios, which were relatively low in Indonesia, recovered and surpassed the pre-1997 crisis levels after 2003, a significant portion of government expenditure was incurred on account of debt servicing. It is seen that the large interest payments that the government had to make on its public debt commitments due to the consequences brought on by excessive financial liberalisation and the open capital account, together with the IMF's inability to prescribe counter-cyclical monetary and fiscal policies, carried a significant opportunity cost in terms of the government's reduced ability to undertake necessary public spending for investment and development expenditures and led to the adverse distributional outcomes. Capital expenditures remain low for such a vast country with huge regional and provincial inequalities, which call for significant public investments for improving infrastructural facilities and public service delivery. Further, social expenditures other than those in education also continue to remain abysmally low.

Although subsidies have played a significant role in keeping prices low and contributed to the reduction in poverty between 1997-98 and 2005, the shift in the composition of subsidies with the increasing share of electricity subsidy and declining share of fuel subsidy during 2006-09 seems to be more in favour of the middle and upper income groups than lower income groups. But following the 2008 global crisis and recession, there has been an increase in the share of non-energy subsidies such as food and fertiliser subsidies in recent years, which is more beneficial to lower income groups and the agriculture sector. Data for social assistance available from 2001 onwards also shows that its share in total central government expenditure increased.

Thus while Indonesia's expenditure-GDP ratios have remained quite low, it does appear that the most recent years have seen some improvement in spending directed towards the lower income groups, which was necessitated to deal with the adverse impact of the global economic slowdown on the economy. But the expansion in informal employment in the country in the aftermath of the global recession is a matter of serious concern given that informal workers have little or no social protection.

Further, despite the overall impressive economic performance and the ambitious decentralisation programme, the impact of economic growth and more critically of public service provision has not been shared equally across provinces. In this context, it is very significant to note that the share of central government expenditures has shown a decline since 2001 and that of regional budget expenditures has shown an increase corresponding with the beginning of the decentralisation program. But given that the regional governments' actual spending has not been rising, the current pattern of fiscal decentralisation might be contributing to a worsening of existing regional and provincial disparities.

The prevalence of vast disparities in income and social indicators across and within provinces points to the huge challenges faced by Indonesia in mobilising greater resources domestically for increasing public expenditure. It is suggested that apart from removing the inequalising exemptions in income taxes and VAT, there is much scope for increasing the land and building tax rate, both from an equity point of view and for increasing revenue mobilisation. Similarly, the share of luxury tax in total revenue, which is abysmally low, can also be increased.

At the level of macroeconomic policy, while the orthodox policy prescription is that fiscal conservatism is the key to achieving financial and macroeconomic stability, Indonesia's experience shows that maintaining financial stability – that cannot be achieved under policies of unfettered financial liberalisation and open capital accounts – would be key to implementing fiscal policy choices that improve distributional outcomes for achieving national development.

Notes

[*] The author is grateful to Jayati Ghosh for her valuable comments and suggestions. Any errors and omissions that remain are the author's sole responsibility.

[1] The Indonesian official definition of the "poor" refers to people who live under the poverty line of Rp182,636, equivalent to US$16.8 per person per month (BPS, 2010).

[2] Apart from oil and natural gas, Indonesia's natural resources include coal, tin, copper, nickel ore, bauxite, silver and gold, all of which are geographically concentrated.

[3] The share of urban population rose steadily from just over 12 percent in 1950 to about 30 per cent in 1995 and further to nearly 50 percent of the total by 2007 (Mishra, 2009).

[4] Mishra (2009) has argued that Indonesian consumer surveys tend to overstate the consumption of poorer households and severely underestimate the consumption of the rich. The larger the proportion of wealthier households in the economy, the greater is the underestimation of household consumption as a proxy for household income. The net result is an unusual uniformity in Gini coefficients generated from such data both over time and across regions and sectors.

[5] See also Akita and Pirmansah (2011).

[6] Indonesia had removed most controls on capital movements in 1970, which facilitated Indonesian firms' access to foreign loans and also led wealthy Indonesians to acquire foreign assets abroad.

[7] During the oil boom, state exercised control over investment not only through public investment, but also to a greater extent through targeted credit programmes operated through state banks. See Pincus and Ramli (2004).

[8] Meanwhile, strategic industries such as automotive industries, petrochemicals, infrastructure projects, forest-based industries and state-vended products continued to be protected.

[9] Apart from banking sector deregulation through abolition of credit ceilings for all banks, controls on lending and deposit rates, curtailment of preferential and targeted lending operated through state banks, etc., financial sector reforms included permission to foreign investors to purchase shares through the stock exchange, permission for the establishment of joint venture companies in banking, insurance and securities, etc. See Rosser (2004).

[10] Since their inception, most Indonesian conglomerates were already held together in a web of cross-holdings and inter-linked directorships, which also involved interlocking of commercial, military and political interests in public and government-favoured enterprises. See Mishra (2009).

[11] The Indonesian private and banking sectors borrowed heavily in the international markets, especially after 1988. Private long-term debt increased from US$ 6.5 billion in 1989 to US$ 44.5 billion on the eve of the 1997 crisis. Outstanding short-term debt increased from US$ 8 billion to US$ 33 billion, and Indonesia received US$ 13 billion and US$ 22.4 billion in net portfolio investment and net FDI, respectively, over the same period. According to Pincus and Ramli (2004), the build-up of external debt was used to accumulate foreign assets by Indonesian investors.

[12] A significant component of the current account deficit was debt service payments on international loans accumulated by both the public and private sectors. Indonesia's total debt was of the order of USD 136 billion in 1997, half of which was that of the private sector. This implied a debt-service ratio in excess of 40 per cent. See Ramli and Nuryadin (2009).

[13] Until the reforms, sub-national units were only nominally autonomous. In a practice known as deconcentration, the regional administration of public affairs operated via a hierarchical and parallel system, wherein central government ministries and agencies operated at the regional level and reported to their respective parent organisations. These deconcentrated agencies have, for the most part, been abolished as part of decentralisation and the regional offices now report to the newly elected regional governments themselves. See Kim and Smoke (ed.) (2003); Bambang (2004); and Blöndal, et al (2009).

[14] At the same time, there was sharply higher interest expenditure on public debt. More discussion on this follows later.

[15] Apart from the fallout of the 1997 crisis, other negative growth factors included the 1999 East Timor crisis, the global economic slowdown following the September 2001 terrorist attacks in the United States, and the serious impact on tourism and the Indonesian economy generally of the Bali bombing in October 2002.

[16] Apart from the fiscal rule to maintain fiscal deficit at a maximum of 3 per cent of GDP, there are also other laws that relate principally to the requirements for detailed input controls and to various "fences" designed to promote "fiscal responsibility" and the prudent use of public money. Blondal et al (2009) argued that the trauma associated with the 1997 financial crisis and Indonesia's endemic problems with corruption were behind the emphasis on such detailed input controls, which were viewed as forming the basis for greater accountability for the use of funds.

[17] There were further increases in utility prices under IMF conditionalities, which carried on into early 2003. See Francis (2003).

[18] It is often argued that large fiscal deficits could fuel either inflation or larger external deficits, which in turn could cause macroeconomic instability. However, as seen in other countries and in Indonesia, it is financial liberalisation and open capital accounts that create macroeconomic instability and crisis.

[19] There are 33 provinces and 348 kabupaten/kota in Indonesia. Kabupaten/kota are the administrative divisions below the provincial government. Kabupaten is generally translated as regency or district and kota means city. The difference between the two is that kota is dominated by urban activities, including manufacturing, trade, service, and hospitality, meanwhile kabupaten economic activities are driven by more rural-based sectors such as agriculture and agro-business. See Blondal et al (2009), Aritenang (2009), etc.

[20] With the devaluation of the rupiah during the East Asian financial crisis, a number of agricultural items in which Indonesia is self-sufficient such as palm oil, became very competitive in the world market. The government thought that this could lead to domestic shortages if exports materialised, and add to the inflationary pressure. To deal with such a possibility, the Government had introduced temporary export bans on rice, wheat, wheat flour and other basic commodities in 1997.

[21] See also Brondolo, Silvani and Bosch (2008).

[22] PWC, 2011

[23] This is also pointed out by Aritenang (2009).

[24] This discussion on local level revenue mobilisation draws on Kim and Smoke (2003), Bambang (2004) and Blondal et al (2009).

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