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PPAA/94/21

INTERNATIONAL MONETARY FUND

Southeast Asia and Pacific Department

Fiscal Adjustment in an Oil-Exporting Country: The Case of Indonesia

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October 1994

Abstract

Faced with declining earnings from oil exports, Indonesia has mounted a sustained fiscal adjustment effort over the last decade. The budget deficits that emerged as oil tax revenues collapsed in the mid-1980s were promptly contained through cuts in public expenditure. Tax reform, together with efforts to broaden the non-oil tax base, subsequently helped restrain the fiscal deficit despite a partial recovery of public investment. While the external public debt ratio has been on a downward trend in recent years, continued efforts would be required to bring the public finances to a position that can be sustained as oil resources are depleted.

MASTER FILES
ROOM C-525
001

JEL Classification Number:
E62

1/ I would like to thank, without implicating, Marco Cangiano, Bob Hagemann, John Hicklin, George Iden, Bruce Smith, and Rachel van Elkan for comments or suggestions on earlier drafts of this paper.

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I. Introduction

From the early years of the New Order Government in the late 1960s, the Indonesian authorities have placed primary emphasis on the need to maintain a sound fiscal policy. This was initially necessary to restore financial stability and halt the high rate of inflation that had been fueled by the monetary financing of budget deficits through the mid-1960s. To prevent a recurrence of such problems, a balanced budget rule instituted in 1968 has virtually ruled out government borrowing in the domestic market.

As oil revenues were spurred by the oil price increases of 1973-74 and 1979-80, development expenditure (i.e., public investment) became an increasingly important tool for the achievement of social and economic objectives. Prominent among these was the building of human capital and infrastructure, which could support a sustained improvement in living standards. To alleviate poverty and promote a more equal distribution of income, a large share of development outlays was directed to the less developed rural areas and outer islands.

Following the weakening of oil revenues in the early 1980s, a widening fiscal deficit prompted a reassessment of policy priorities. Initially, the decline in oil tax receipts was partly offset by increasing recourse to external borrowing, and development expenditure remained high. But, in the process, the Government accumulated a growing stock of external debt, which became all the more burdensome as export earnings were compressed by collapsing oil prices. Under these circumstances, a bold adjustment effort was initiated in the mid-1980s. In the fiscal area, development expenditures were sharply reduced and the tax system was reformed, with a view to limiting the Government's dependence on oil revenue. At the same time, trade and investment were deregulated, the exchange rate was devalued, and the financial system was liberalized.

The purpose of this paper is to draw some of the lessons from Indonesia's adjustment effort to date and to identify the principal challenges for fiscal policy in the period ahead. Section II describes the balanced budget rule and explains the ways in which it may have affected policy

outturns during the different phases of the oil price cycle. Section III discusses key aspects of the policy response to the oil counter-shock of the 1980s. Lessons from the Indonesian experience and future policy challenges are discussed in Section IV.

II. Balanced Budget Rule

The conduct of fiscal policy in Indonesia follows the principle of the so-called dynamic balanced budget. This means that budgeted expenditure for any given fiscal year must be exactly equal to projected revenue as defined in the budget, i.e., including net receipts from foreign loans. If, during the course of the year, revenue is expected to deviate from budgetary projections, actual expenditure must be adjusted so as to balance the budget at a lower or higher level of realized revenue. ^{1/}

The balanced budget rule does not necessarily ensure fiscal discipline. This became evident following the two oil price surges of the 1970s. Although the Government tried to smooth the allocation of oil receipts to the budget, by temporarily depositing some of the windfall in the so-called oil transitory account at Bank Indonesia (the central bank), public expenditure doubled between 1973/74 and 1975/76 and, again, between 1978/79 and 1980/81. ^{2/} In both instances, inflation surged to more than 30 percent, ultimately leading to large devaluations. It could be argued with the benefit of hindsight that, because the rise in real oil prices was temporary, it would have been appropriate to save a greater fraction of the windfall. But the balanced budget rule did not explicitly allow such intertemporal smoothing, making it difficult to check the increase in public expenditure.

The treatment of foreign financing as revenue, moreover, can provide considerable discretion in the setting of borrowing and expenditure targets. This became especially relevant as Indonesia's

^{1/} Directorate General of Budget (1993).

^{2/} Indonesia's fiscal year begins on April 1.

creditworthiness was boosted during the years of the oil boom, and year-to-year fluctuations in the Government's net foreign borrowing were wide throughout the 1980s. A more conventional measure of the budget deficit (treating foreign loans as financing) would show substantial year-to-year fluctuations in the overall fiscal balance, with large cumulative effects on the stock of public debt. The ratio of external public debt to GDP indeed rose from less than 20 percent in the early 1980s to 50 percent in 1986/87, before declining gradually thereafter (Table 1 and Chart 1).

Despite its shortcomings, the balanced budget rule has played an important role in limiting the buildup of public debt. With external borrowing consisting mainly of official funds provided by the Inter-Governmental Group on Indonesia (IGGI), 1/ the rule was probably a binding constraint on public spending until the first oil boom. More recently, the Indonesian authorities have aimed at reducing the foreign debt exposure, especially for commercial debt, and the share of outstanding new loans from the IGGI--largely on concessional terms--rose from 70 percent in 1986/87 to 90 percent in 1992/93. By precluding the issuance of domestic debt, the balanced budget rule helped to keep the overall burden of public debt at a manageable level.

The requirement that the budget be always balanced is also likely to have strengthened the ability of policymakers to make decisive cuts in expenditure during times of declining oil revenue, while allowing them some flexibility to smooth short-run fluctuations. Based on the record to date, flexibility was most often used on the side of caution, albeit not always in a transparent fashion. As already noted, this was sometimes done by temporarily placing oil revenues, as well as other nontax receipts, into extra budgetary accounts with Bank Indonesia. Expenditures were also restrained by including in the budget, under development expenditure, periodic deposits to those accounts. The Government could thus sterilize--or, less frequently, supplement--accrued revenue, by relying on

1/ IGGI was replaced by the Consultative Group for Indonesia (CGI) starting July 1992.

Table 1. Indonesia: Summary of Central Government Operations, 1980/81-1992/93 1/

	1980/81	1981/82	1982/83	1983/84	1984/85	1985/86	1986/87	1987/88	1988/89	1989/90	1990/91	1991/92	1992/93 Est.
(In billions of rupiah)													
Tax revenue	9,911	11,876	11,983	13,914	15,218	17,761	13,984	18,826	21,435	26,678	37,431	39,098	44,459
Oil/gas	7,020	8,628	8,170	9,520	10,430	11,145	6,338	10,047	9,527	11,252	17,712	15,039	15,330
Non-oil/gas	2,891	3,248	3,813	4,394	4,788	6,616	7,646	8,779	11,908	15,426	19,719	24,059	29,129
Nontax revenue	316	337	435	519	687	1,492	2,157	1,977	1,569	2,062	2,115	2,487	2,993
Grants	122	118	73	111	72	123	162	272	283	306	422	414	511
Total revenue and grants	10,349	12,331	12,491	14,544	15,977	19,376	16,303	21,075	23,287	29,046	39,968	41,999	47,963
Current expenditure	6,217	7,460	7,308	8,305	9,618	11,419	12,510	14,021	15,035	18,358	23,145	22,933	25,854
Of which:													
Personnel	2,023	2,277	2,418	2,757	3,047	4,018	4,311	4,617	4,998	6,201	7,054	8,103	9,466
Subsidies	1,305	1,687	1,382	1,249	1,239	851	467	1,158	333	984	3,566	1,332	867
Interest on external debt	408	461	620	1,116	1,492	1,704	2,988	3,435	4,403	4,819	5,031	4,562	5,385
Current budget balance	4,133	4,870	5,182	6,239	6,359	7,957	3,793	7,054	8,253	10,688	16,823	19,067	22,161
Development expenditure													
and net lending 2/	3,487	6,377	8,510	9,645	6,144	11,179	9,182	8,247	12,467	12,213	13,902	20,398	25,480
Total expenditure and net lending	9,703	13,838	15,818	17,950	15,762	22,598	21,692	22,268	27,502	30,571	37,047	43,330	51,333
Overall balance	646	-1,507	-3,327	-3,406	215	-3,222	-5,389	-1,193	-4,214	-1,525	2,921	-1,331	-3,319
Financing	-646	1,507	3,327	3,406	-215	3,222	5,389	1,193	4,214	1,525	-2,921	1,331	3,319
Domestic 3/	-1,821	-103	647	-1,185	-2,479	1,342	836	-1,051	-323	-1,440	-4,226	-1,053	2,010
Foreign, net 4/	1,175	1,610	2,680	4,591	2,264	1,880	4,553	2,244	4,538	2,965	1,305	2,383	1,309
Gross drawings	1,561	2,125	3,305	5,583	3,619	3,722	7,556	7,272	10,959	9,553	8,934	10,634	11,207
Amortization	-386	-515	-624	-993	-1,355	-1,842	-3,003	-5,028	-6,422	-6,588	-7,629	-8,251	-9,898
(In percent of GDP)													
Overall balance	1.3	-2.4	-4.8	-4.2	0.2	-3.3	-5.0	-0.9	-2.8	-0.9	1.4	-0.6	-1.4
Excluding oil/gas revenue	-12.4	-16.3	-16.7	-16.0	-11.1	-14.6	-10.8	-8.7	-9.3	-7.3	-7.3	-7.0	-7.2
Current budget balance	8.1	7.8	7.5	7.7	6.9	8.1	3.5	5.5	5.6	6.1	8.3	8.2	8.3
Total revenue and grants	20.2	19.8	18.2	18.0	17.4	19.7	15.1	16.3	15.7	16.7	19.7	18.0	18.0
Oil/gas	13.7	13.8	11.9	11.8	11.4	11.3	5.9	7.8	6.4	6.5	8.7	6.4	5.7
Non-oil/gas taxes	5.6	5.2	5.5	5.4	5.2	6.7	7.1	6.8	8.0	8.9	9.7	10.3	10.9
Nontax revenue	0.6	0.5	0.6	0.6	0.7	1.5	2.0	1.5	1.1	1.2	1.0	1.1	1.1
Grants	0.2	0.2	0.1	0.1	0.1	0.1	0.1	0.2	0.2	0.2	0.2	0.2	0.2
Total expenditure and net lending	18.9	22.2	23.0	22.2	17.2	23.0	20.0	17.2	18.5	17.5	18.2	18.5	19.4
Current	12.1	12.0	10.6	10.3	10.5	11.6	11.6	10.9	10.1	10.5	11.4	9.8	9.7
Of which:													
Interest on external debt	0.8	0.7	0.9	1.4	1.6	1.7	2.8	2.7	3.0	2.8	2.5	2.0	2.0
Development	6.8	10.2	12.4	12.0	6.7	11.4	8.5	6.4	8.4	7.0	6.8	8.7	9.7
External government debt	16.0	15.1	18.2	26.0	25.4	31.3	30.3	49.5	48.0	42.2	42.7	38.4	39.5

Sources: Data provided by the Indonesian authorities; and staff estimates.

1/ The fiscal year begins on April 1.

2/ Derived as the sum of the current budget balance and net financing.

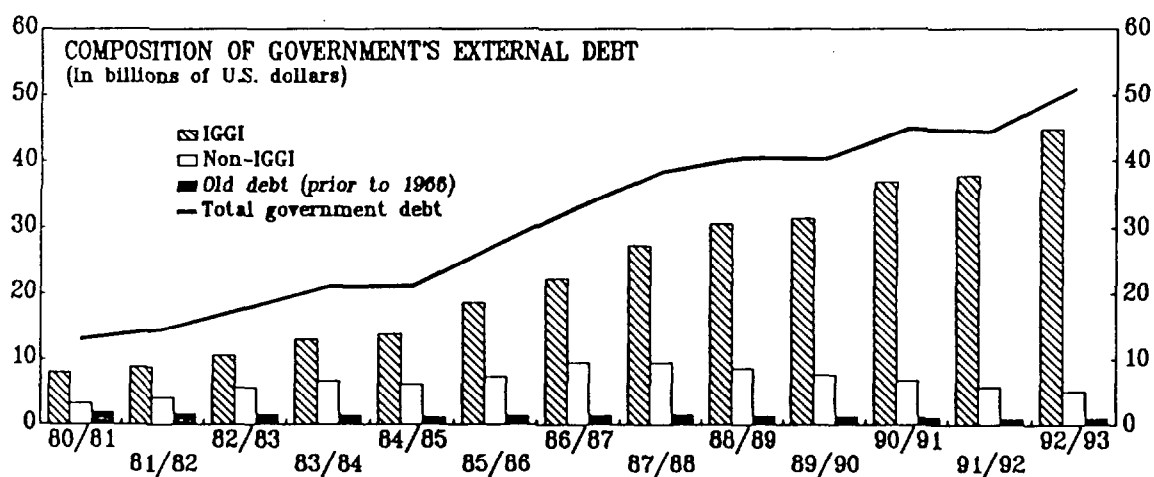
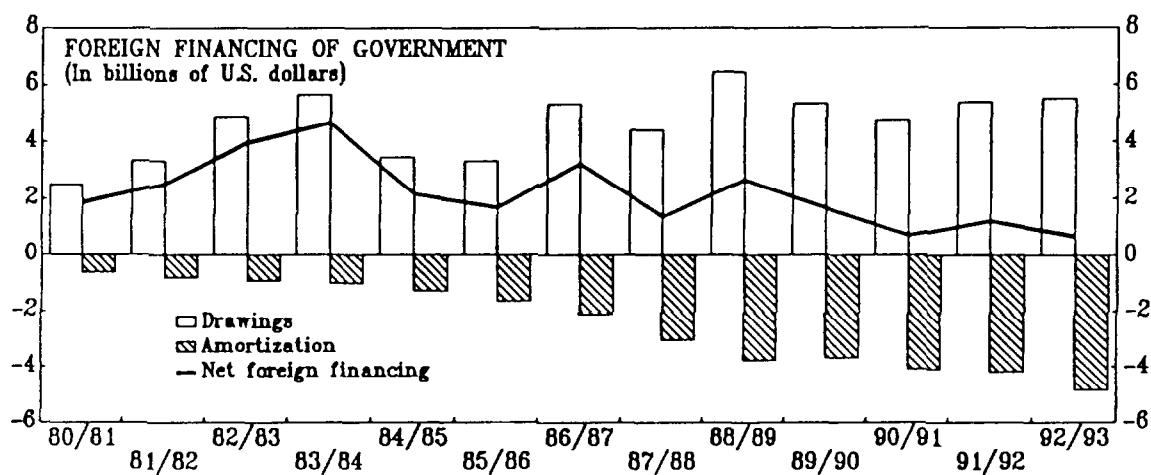
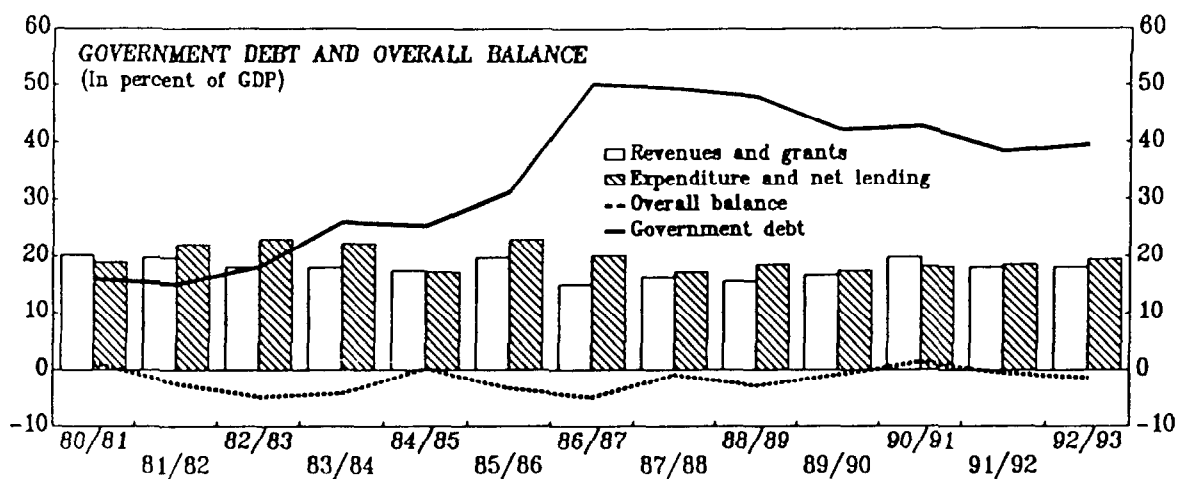
3/ Change in net government deposits with the domestic banking system.

4/ As derived from the balance of payments accounts.

CHART 1

INDONESIA

SUMMARY FISCAL INDICATORS, 1980/81-1992/93



Sources: Data provided by Bank Indonesia, Research Department (URES); Ministry of Finance, Directorate General of Budget; and staff estimates.

negative—or, at times, positive—financing from Bank Indonesia. In the process, the net government balance with Bank Indonesia rose more or less steadily from near zero in the mid-1970s to a peak of almost Rp 20 trillion or the equivalent of 8 1/2 percent of GDP in 1991/92, before declining to Rp 17 1/2 trillion (6 1/2 percent of GDP) in 1992/93.

The flexible enforcement of the balanced budget rule has become more transparent in recent years. A portion of the budgeted development expenditure (Rp 2 trillion, equivalent to 1 percent of GDP) was explicitly set aside as a development budget reserve (CAP) for the first time in 1990/91 to sterilize some of the windfall from the oil price increase in the wake of the Middle East crisis. Oil revenues declined thereafter, but a buoyant increase in non-oil/gas tax receipts in 1991/92 was again partially sterilized by a further contribution (Rp 1.5 trillion) to the development budget reserves. In 1992/93, there was no explicit contribution and, for the first time since the mid-1980s, there was, instead, a drawdown of net government deposits with Bank Indonesia, which reflected, in part, outlays for the recapitalization of state banks. The flexible management of the balanced budget rule was finally given formal recognition in the "Guidelines of State Policy" issued in March 1993 for the sixth five-year development plan. ^{1/}

III. Fiscal Performance Since the Second Oil Price Surge

1. Overall fiscal balance and the external current account

One convenient way to gauge some of the effects of fiscal policy is in terms of its contribution to the economy-wide, savings-investment gap. That gap, which is basically equal to the external current account balance, reflects the fact that some economies do not generate sufficient savings to finance all profitable domestic investment opportunities. By relying on foreign savings,

^{1/} According to those guidelines, fiscal policy is to be based again on the principle of a dynamic balanced budget "with the possibility of reserve fund provision when the state receives surplus revenue, and the use of the reserve fund when the revenue is less than expected and thus unable to support the already-planned programs and/or unexpected programs" (The People's Consultative Assembly (1993), p. 116).

these economies may enhance GDP growth prospects, while at the same time improving the allocation of world savings. An obvious caveat is that markets sometimes withhold financing from countries whose level of external debt is perceived to jeopardize their capacity to service that debt in the future. This calls for a cautious and disciplined approach toward the use of foreign savings. Overall reliance on foreign savings reflects both the private sector's and the Government's savings and investment decisions, and the final impact of these decisions on the external current account can be captured by the respective sectoral savings-investment balances.

Movements in the Government's savings-investment balance, which is equal to the conventionally defined overall fiscal balance, accounted for the bulk of the current account deficits that emerged in 1981/82-1986/87 (Chart 2). This is not surprising as both government revenues and current receipts are directly affected by developments in oil exports. The close relationship between the overall fiscal balance and the balance of payments of oil-exporting countries is indeed well documented. ^{1/} What is noteworthy about the Indonesian experience is that the widening fiscal deficit initially reflected a sharp increase in public investment. The public savings ratio, by contrast, was broadly stable through the early-1980s, and it dropped sharply only in the mid-1980s as oil prices collapsed. A sustained recovery in government savings, together with a more restrained pace of public investment, helped improve the external position thereafter.

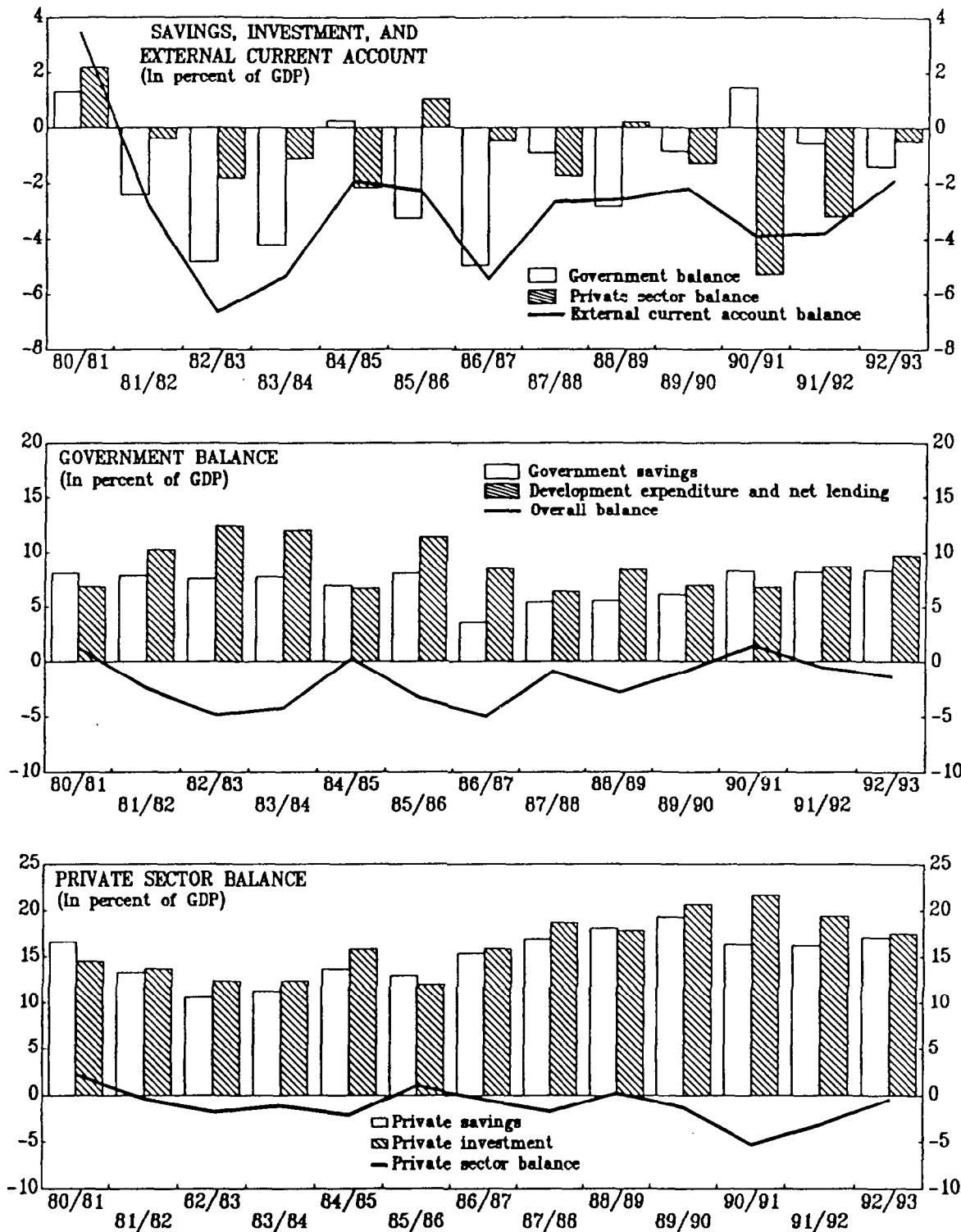
With fiscal policy remaining cautious, private sector behavior has in recent years had an increasingly important impact on the external accounts. A declining private savings ratio already contributed to the widening of the current account deficit in the early 1980s. Private savings recovered rapidly thereafter, making it possible to finance a steadily rising investment ratio without much recourse to foreign savings. Nonetheless, private savings leveled off in the early 1990s, while private investment boomed in the wake of deregulation, and the current account deficit

^{1/} See, for example, Morgan (1979).

CHART 2

INDONESIA

SAVINGS-INVESTMENT BALANCES, 1980/81-1992/93



Sources: Data provided by Bank Indonesia, Research Department (URRS); Ministry of Finance, Directorate General of Budget; and staff estimates.

widened markedly. To contain demand pressures and check the rapid buildup of external debt, the Indonesian authorities tightened monetary policy and imposed administrative controls on project-related offshore borrowing by the public sector.

The ease of financing larger private sector imbalances has given rise to new opportunities and challenges. The upsurge in private sector investment since the mid-1980s has made it possible to support a more rapid rate of economic growth without unduly burdening the development budget. The economy-wide investment ratio indeed rose from an average of about 24 percent of GDP in 1981/82-1986/87 to 27 percent in 1987/88-1992/93, as a sharp increase in private investment more than offset a more modest decline in the public investment ratio (Chart 3). Aside from the obvious benefits for the fiscal accounts, the shifting composition of investment seems to have been accompanied by gains in the productivity of capital, as evidenced by a decline in the incremental capital output ratio (ICOR). At the same time, however, the dynamic growth of private investment has made the private sector imbalance a more likely source of resource strains than in the past. This has posed a new challenge for demand management, as evidenced by the fact that attempts to tighten the monetary stance have been frustrated by increasing capital inflows.

2. Oil-adjusted balance, fiscal stance,
and long-run policy targets

Given the central influence of oil market developments on the overall fiscal balance, it is worth considering alternative indicators of fiscal stance that account for some of the special features of oil revenue. For purposes of demand management, it is important to note that, unlike most other taxes, revenue from oil exports does not withdraw any purchasing power from the domestic economy. As a result, changes in the government balance that reflect fluctuations in oil exports should have no direct effect on domestic demand. By contrast, changes in government expenditure financed with changes in oil revenue may have powerful effects on domestic demand, even if the overall fiscal balance remains unaffected.

To address these difficulties, one frequently used measure of the fiscal stance is the domestic currency balance. This includes only transactions that have a direct effect on the domestic economy, so as to better capture the impact of government actions on domestic liquidity and inflation. ^{1/} Government transactions with the rest of the world are excluded, except to the extent that they are accompanied by foreign currency sales to, or purchases from, the domestic private sector. In practice, it is not always easy to identify the import content of government spending. In addition, by excluding foreign-financed government imports, the domestic currency balance misses the important effects of fiscal imbalances on the buildup of external debt.

A simpler alternative is the oil-adjusted overall balance (i.e., the balance excluding oil revenue). Like the domestic currency balance, the oil-adjusted balance reflects the true effects of oil-related budgetary developments on domestic demand, as it captures changes in oil revenue that are compensated by equal changes in expenditure, while disregarding uncompensated changes in oil revenue. The oil-adjusted balance is also a more reliable measure of discretionary fiscal policy than the unadjusted balance, which is subject to oil revenue instability that is most often unrelated to policy factors. A comparison of these balances for Indonesia indeed shows that adjusting for oil eliminates much of the year-to-year variability in the fiscal balance, making it easier to assess long-run policy trends (Charts 2 and 4).

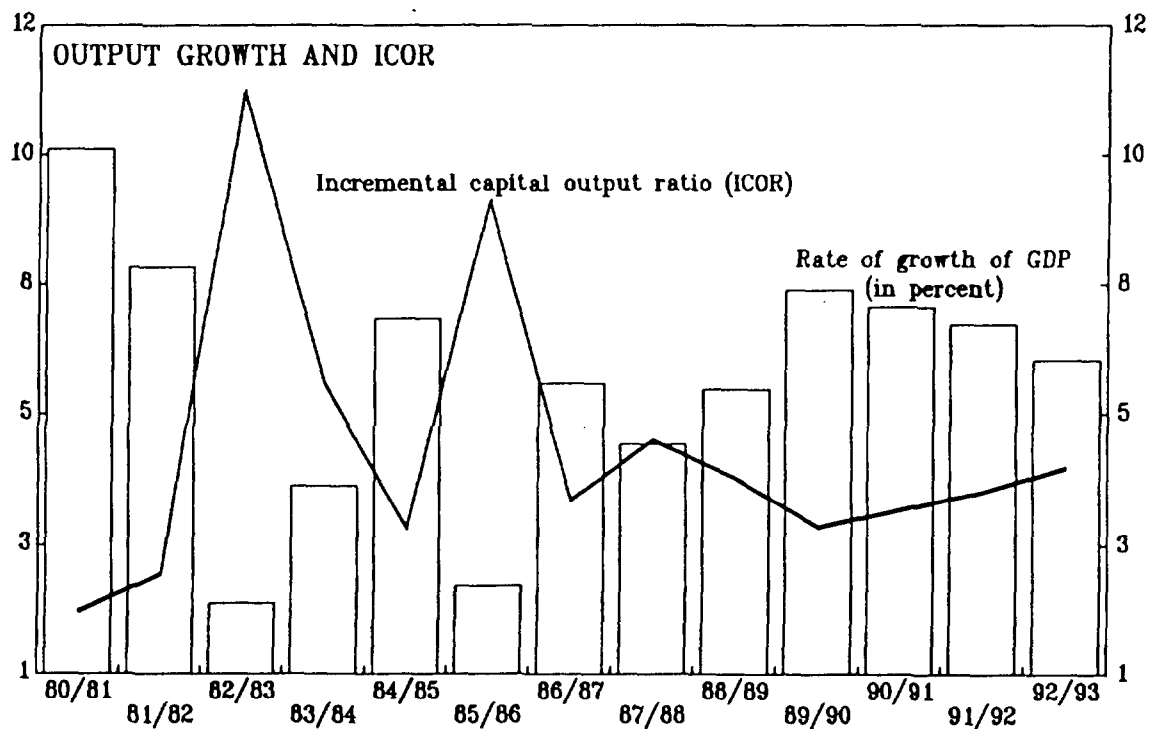
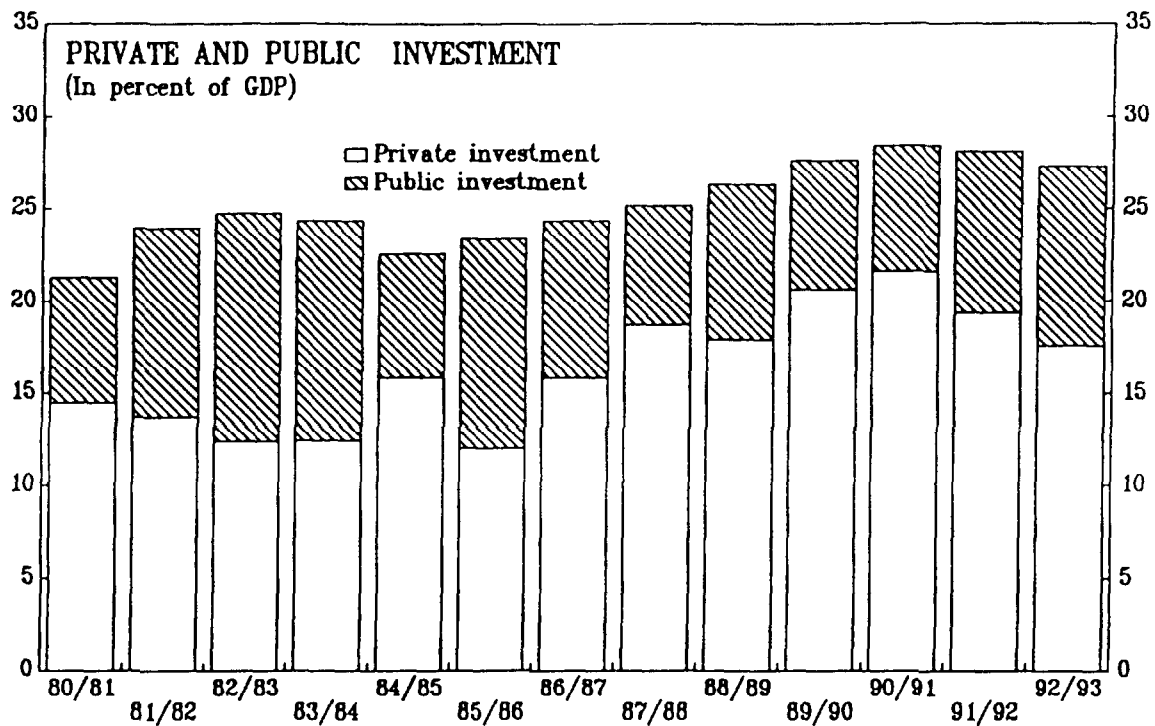
The evolution of the Government's oil-adjusted balance suggests that the fiscal adjustment effort became progressively stronger through most of the 1980s, but leveled off in the early 1990s. The Government's oil-adjusted savings balance rose from a deficit of 6 percent of GDP in 1981/82 to near balance in 1989/90. As already noted, a more restrained pace of development expenditure also contributed to the adjustment effort during the latter part of that period. Since then, however, the fiscal policy stance appears to have been broadly neutral. With a continuing improvement in the

^{1/} See, for example, Samii (1982).

CHART 3

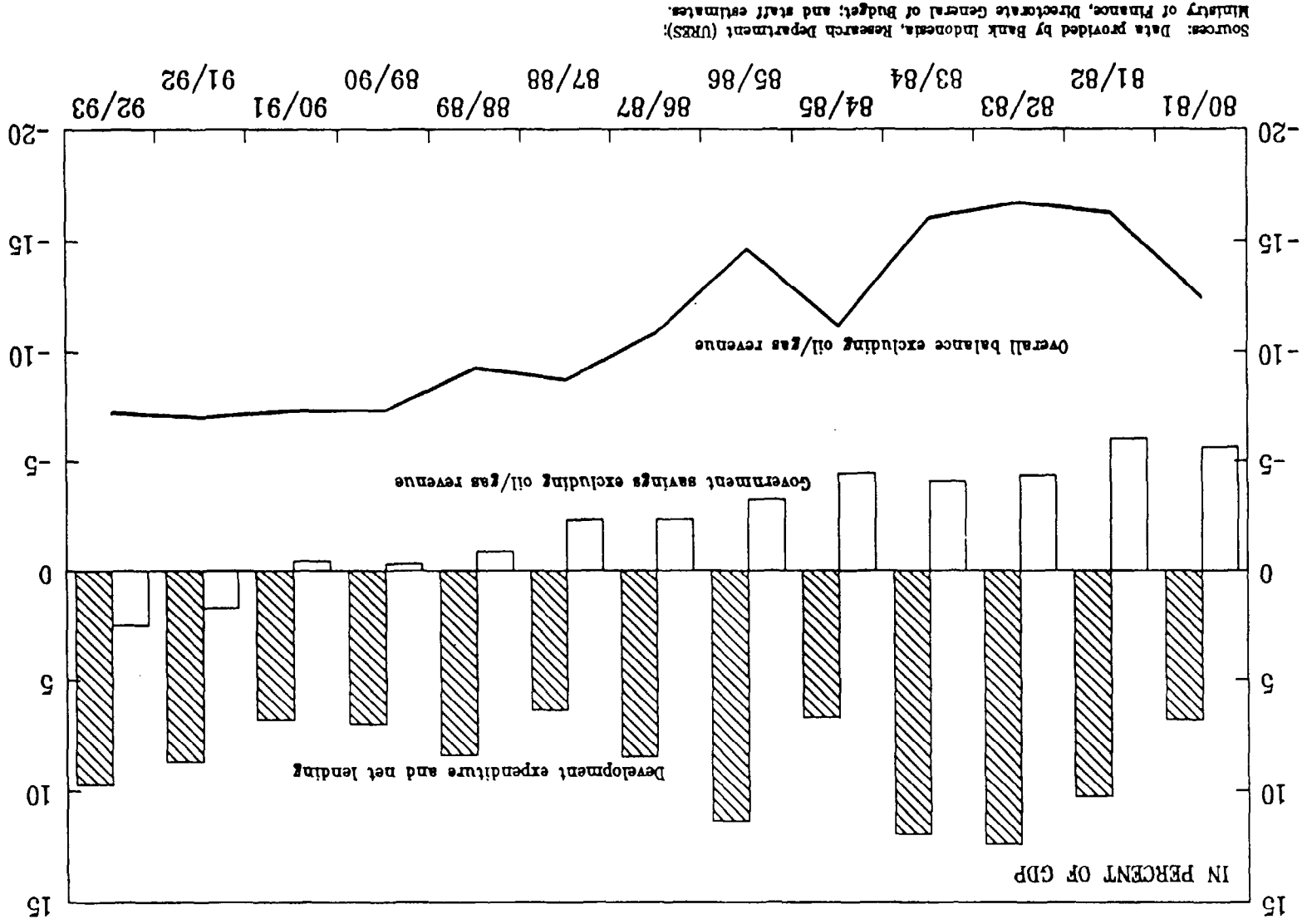
INDONESIA

GROWTH AND INVESTMENT, 1980/81-1992/93



Sources: Data provided by Bank Indonesia, Research Department (URES); Ministry of Finance, Directorate General of Budget; and staff estimates.

CHART 4
INDONESIA
ADJUSTED GOVERNMENT SAVINGS AND INVESTMENT, 1980/81-1992/93



Sources: Data provided by Bank Indonesia, Research Department (URS); Ministry of Finance, Directorate General of Budget; and staff estimates.

savings balance offset by a recovery in the public investment ratio, the burden of stabilization has consequently fallen mostly on monetary policy. ^{1/}

From a longer-run perspective, the oil-adjusted balance serves to account for the fact that oil is an exhaustible resource. Assuming that the Government is the sole owner of oil wealth, oil-related receipts could be viewed as revenues from the sale of an asset. The conventional measure of the fiscal balance would, accordingly, overstate government saving until all oil wealth is depleted, and it would therefore provide a misleading picture of the sustainability of fiscal policy. ^{2/} The simplest way to account for oil as an asset is by treating oil revenue as a financing item, which reduces the fiscal position to the oil-adjusted balance.

In this light, the oil-adjusted balance provides a useful benchmark for the setting of sustainable, longer-run policy objectives. Even if there is no explicit stabilization mechanism to guarantee a flow of permanent income from oil wealth, the Government can set its fiscal targets so as to prepare for the eventual depletion of oil. A first approximation of the long-run effort required to smooth the path of public investment is provided by the oil-adjusted overall balance. In Indonesia, that balance recorded a deficit equivalent to about 7 percent of GDP in 1992/93. Public savings would accordingly need to be increased by some 7 percentage points of GDP over the next 15-20 years, if the goal is to maintain a balanced budget and a steady pace of capital expenditure following the depletion of oil reserves.

3. Trade liberalization, tax reform, and the revenue effort

As in the case of the overall balance, oil market developments have tended to conceal the effectiveness of Indonesia's revenue effort. Overall revenue performance has been lackluster since

^{1/} Aside from oil-related effects, revenue performance is also known to depend on cyclical factors. In interpreting the stance of fiscal policy, another useful exercise would be to calculate the cyclically adjusted balance.

^{2/} The shortcomings of conventionally measured fiscal deficits and the case for a more comprehensive accounting of changes in public sector net worth are discussed in Buitier (1983).

the early 1980s, with the revenue ratio declining more or less steadily between 1980/81 and 1986/87, and recovering only partially thereafter (Chart 5). However, the weakening performance during the early part of that period was more than accounted for by the gradual erosion and, subsequently, sharp fall in oil tax receipts. Oil revenues recovered somewhat in the late 1980s as international oil prices rebounded. But the greatest strides were made in the taxation of the non-oil/gas sector, which had been neglected in the years of plentiful oil revenues. Following far-reaching reforms in the trade and tax systems, non-oil/gas taxes rose steadily from 5 1/2 percent of GDP in the first half of the 1980s to 11 percent of GDP by 1992/93.

The taxation of international trade was directly affected by the reform measures initiated in the mid-1980s. As was already noted, to promote the development of competitive export-oriented industries, there were two major devaluations of the rupiah--by 28 percent vis-à-vis the U.S. dollar in 1983 and by another 31 percent in 1986--coupled with a wide-ranging liberalization of trade regulations. The real effective exchange rate depreciated by about 50 percent between 1980 and 1987. This moderated the effect of declining oil prices on rupiah tax receipts, while also helping enlarge the import tax base in relation to GDP. ^{1/} Beginning in 1985, import tariffs were progressively lowered, with the ad valorem tariff ceiling declining from 225 percent to 60 percent; the number of tariff categories was reduced from 25 to 11; and many nontariff barriers were removed. On the export side, licenses were abolished for most products, and a duty exemption/duty drawback scheme for imported inputs was introduced.

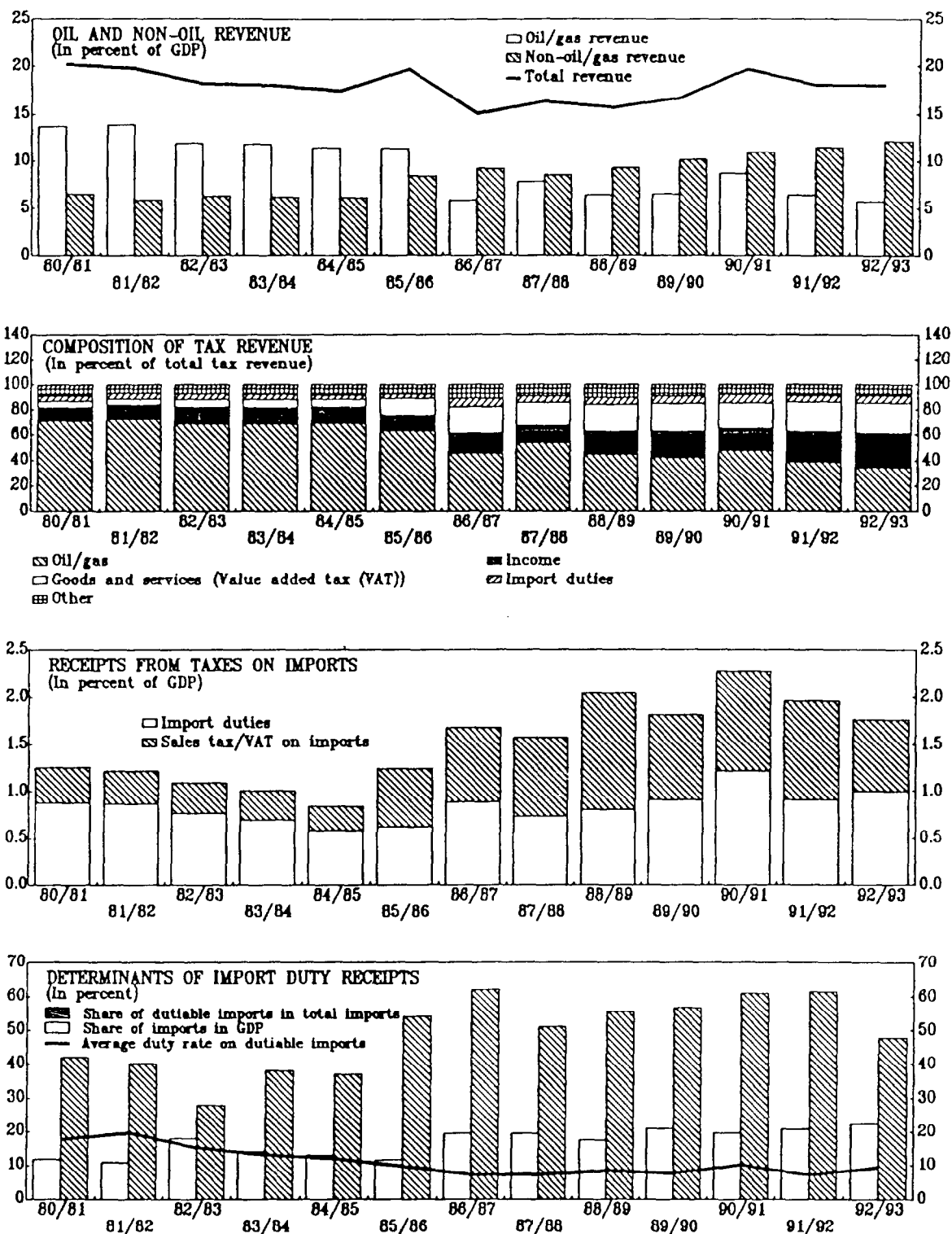
Import duty receipts, which had stagnated until the mid-1980s, rose rapidly following the liberalization measures. Although the decline in tariffs led to a marked reduction in the average duty rate on dutiable imports, this was more than offset by sharp increases in the ratio of imports to GDP and in the share of dutiable imports in total imports. Underlying these developments were the

^{1/} For a discussion of the channels through which devaluation can improve fiscal revenue performance, see Nashashibi and Bazzoni (1994).

CHART 5

INDONESIA

DEVELOPMENTS IN FISCAL REVENUE, 1980/81-1992/93



Sources: Data provided by Bank Indonesia, Research Department (URES); Ministry of Finance, Directorate General of Budget; and staff estimates.

combination of a competitive exchange rate, reduced incentives to evade duties, and better enforcement of customs regulations. 1/, 2/

Additional reforms were aimed at broadening the domestic revenue base. The personal and corporate income taxes were revised with effect from 1984. 3/ A complicated and steeply progressive income tax structure was replaced by a simpler system, with three rates--15 percent, 25 percent, and 35 percent--applied to both personal and corporate taxpayers. In addition, more reliance was made on withholding as a means of collecting personal income taxes, and the number of registered taxpayers was increased through improved enforcement.

In April 1985, a sales tax with seven different rates was replaced by a flat value-added tax (VAT) of 10 percent, coupled with a special sales tax of 10 percent or 20 percent on specified luxury goods. The VAT was initially imposed on a relatively narrow base, at the manufacturer-importer level. Small firms, with turnover of less than Rp 60,000,000 per month (Rp 30,000,000 for service firms), were exempt from taxation and exports and capital goods were zero rated. As in the case of the income tax, the number of registered VAT taxpayers increased sharply following the reform.

In January 1986, finally, a new property tax law consolidated IPEDA, a tax paid mainly by landowners in rural areas, with six other property taxes. The new tax had only one rate (0.5 percent of the market value of the property), compared with 12 different rates under the old system, and it was imposed on a narrower base of real estate only. This excluded financial assets

1/ Since the mid-1980s, improvements in customs administration have been achieved with the assistance of SGS (Société Générale de Surveillance), a foreign company with expertise in this area.

2/ Combined receipts from import duties and from the VAT on imports more than doubled in relation to GDP between 1984/85 and 1990/91, but they edged down thereafter despite a continuing increase in the import ratio. The more recent developments reflect a decline in the share of dutiable imports in total imports, which may be attributable to a changing composition of imports in favor of duty-exempt inputs for the dynamic export sector and, possibly also, to a waning of the improvement in customs administration.

3/ For a more detailed description of Indonesia's tax reforms, see Asher and Booth (1992).

and other movable properties that were subject to the old wealth tax, so as to facilitate tax administration and improve tax compliance. ^{1/} Buildings with a sales value of Rp 3.5 million or less were not subject to the property tax, effectively exempting most rural housing and a substantial share of low-income urban housing.

The tax reform led to a dramatic transformation of the structure of government revenues. Non-oil/gas income taxes and the VAT accounted for the bulk of the revenue effort, raising their combined share in total taxes from about 20 percent before the reforms to more than 50 percent in 1992/93. The share of oil revenue was virtually halved over the same period--from 68 1/2 percent in 1983/84 to 34 1/2 percent by 1992/93--drastically reducing the budget's vulnerability to oil price declines.

Tax receipts continued to rise much faster than income well after the initial reforms had been completed, reflecting a highly effective mix of further measures to broaden the tax base and strengthen tax administration. Between 1987/88 and 1992/93, the buoyancy of non-oil/gas income taxes and property taxes with respect to GDP averaged 2.0, while the buoyancy of the VAT averaged 1.5. Among the new measures introduced during this period were a withholding tax on deposit interest at a flat rate of 15 percent (November 1988); the extension of the VAT to telecommunications and domestic airline services (January 1989); increases in luxury tax rates and coverage including the introduction of a higher bracket (January 1989 and, again, January 1992); and the extension of the VAT to the wholesale level and most other services (April 1989). Other new measures included the extension of the VAT to large firms at the retail level (January 1992); the taxation of interest income earned by companies at a progressive corporate rate of up to 35 percent rather than the flat withholding tax rate (January 1992); and the extension of the requirement to withhold taxes on rents paid by professionals. Further enhancing the effectiveness

^{1/} For a more detailed description of the pre-reform tax system, see Woo and Nasution (1989).

of these measures were the ongoing efforts by the tax administration authority to strengthen enforcement, by improving and modernizing its auditing and cross-checking capabilities.

Notwithstanding these gains, there is substantial scope for a stronger revenue effort in the period ahead. As of 1992/93, Indonesia's non-oil/gas tax revenue amounted to 11 percent of GDP or about 6 percentage points of GDP below the average non-oil tax ratio in other ASEAN members. Indonesia's relative capacity to levy taxes may have, in the past, been hampered by certain structural characteristics of the economy, including the low levels of per capita GDP and nonexport income, the large share of economic activity in the agricultural sector, and the relatively low level of international trade in relation to GDP. ^{1/} As income growth continues and labor continues to shift from agriculture to more profitable and more highly taxed industries, it should be possible to continue increasing the revenue effort over the medium term even without an increase in tax rates.

4. Expenditure and the debt-service burden

Given the impact of the oil countershock, revenue measures alone could not have brought about a timely fiscal adjustment in the absence of a determined effort to curb expenditure. After peaking at 23 percent of GDP in 1985/86, total expenditure was slashed by 3 percentage points of GDP in 1986/87 (Chart 6). Even so, the overall deficit widened to 5 percent of GDP. Unlike in previous years, a large portion of the deficit had to be financed through nonproject foreign borrowing, including program borrowing and credit from commercial banks. The public debt ratio surged to 50 percent of GDP in 1986/87, spurred also by the real depreciation of the rupiah. In these circumstances, expenditure was cut by another 3 percentage points of GDP in 1987/88. This, together with a partial recovery of oil prices, helped contain the deficit and stabilize the debt-to-GDP ratio. Expenditure was allowed to edge up thereafter, but the buoyant expansion of revenue helped keep the overall deficit in check.

^{1/} For a formal estimation of how such factors may account for cross-country differences in apparent tax efforts, see Tait, Grätz, and Eichengreen (1979).

Development expenditure and net lending, which had been a principal contributor to the deficits of the early 1980s, bore the initial brunt of the adjustment effort, declining from 11 1/2 percent of GDP in 1985/86 to 6 1/2 percent of GDP in 1987/88. Strict criteria were applied for the implementation of most projects, with priority given to the completion of those that were already at an advanced stage, and disbursements for many projects were stretched out. Project implementation was speeded up in 1988/89, but oil revenues again declined, leading to renewed restraint in development expenditure. The fiscal position strengthened thereafter, setting the stage for a partial recovery of development spending from about 7 percent of GDP in 1990/91 to 9 1/2 percent of GDP in 1992/93.

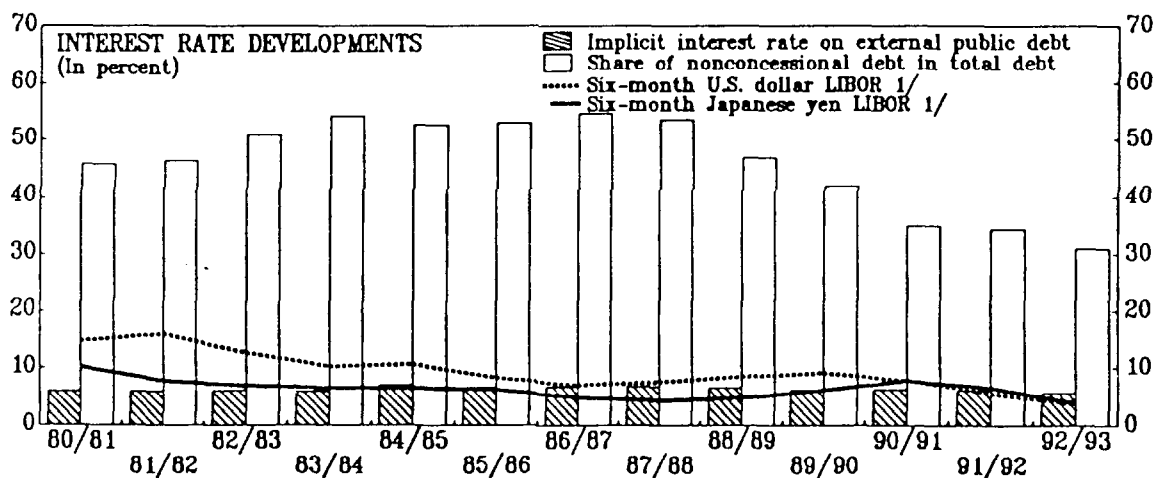
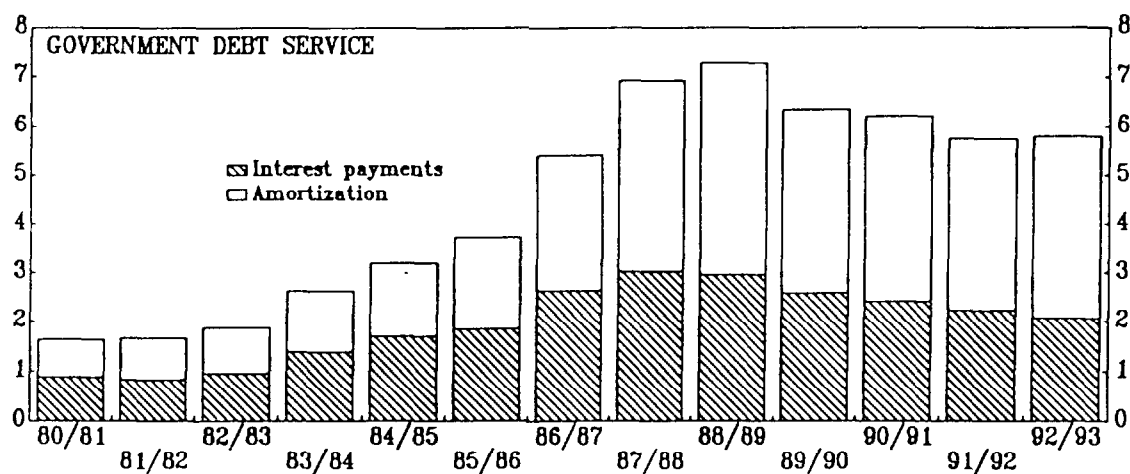
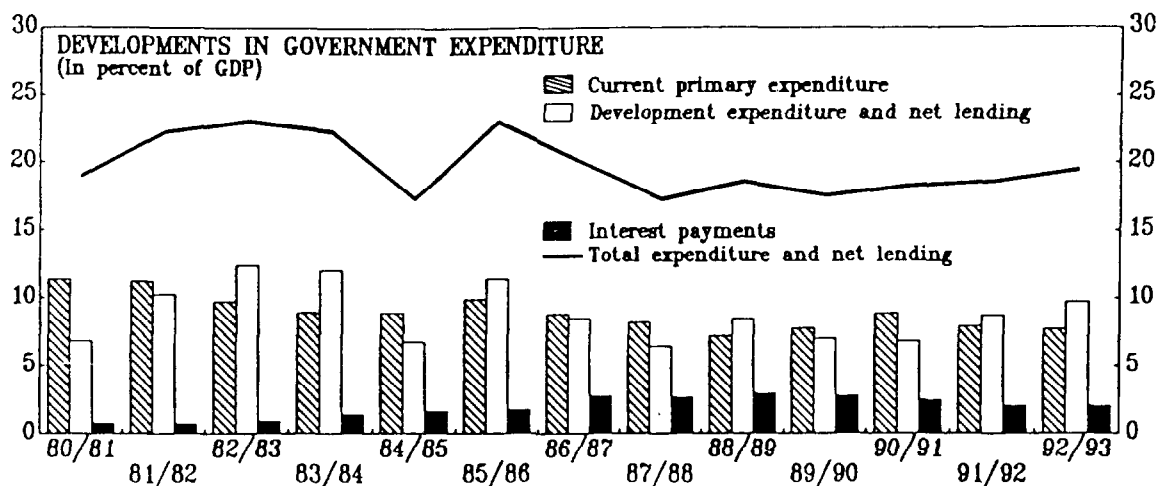
Noninterest current expenditure also made a lasting contribution to the adjustment effort, declining from 10 percent of GDP in 1985/86 to less than 8 percent of GDP by 1992/93. Public sector wages were frozen between 1985 and 1988, and the Government's salary bill was allowed to increase only as needed to cover wage drift and a small increase in employment. Thereafter, real civil service wages were allowed to reverse most of the earlier losses, but a rapid rate of economic growth helped keep the Government's wage bill more or less stable in relation to GDP. ^{1/} Other expenditure categories that were compressed included expenditure on goods and services, transfers to regions, and subsidies.

Petroleum subsidies, in particular, had declined from 2 percent of GDP in the early 1980s to zero by 1986/87, but they resurfaced as oil prices recovered, rising to 1 1/2 percent of GDP in 1990/91. Following three successive adjustments--in May 1990, July 1991, and January 1993--retail prices of most domestic oil products were raised by a cumulative 68 percent to 90 percent.

^{1/} Public sector wages were raised by 15 percent in 1989, 10 percent in 1990, 15 percent in 1991, and 12-18 percent in 1993 (no increase was granted in 1992, except for an increase in spouse allowances from 5 percent to 10 percent of basic salary). By comparison, the rate of inflation was 6.4 percent in 1989, 8.1 percent in 1990, 9.4 percent in 1991, 7.6 percent in 1992, and 9.7 percent in 1993.

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Sources: Data provided by Bank Indonesia, Research Department (URKS); Ministry of Finance, Directorate General of Budget; and staff estimates.

1/ London interbank offered rate.

As a result, real domestic oil prices have increased by a cumulative 20-36 percent since March 1990. The higher oil prices were accompanied by substantial upward adjustments in electricity tariffs and transportation fares, leading to temporary spurts in the rate of inflation. Nevertheless, the longer-run effects of these adjustments are likely to have moderated demand pressures. Indeed, for the first time since 1986/87, the 1993/94 budget recorded a surplus on domestic oil operations.

As public debt surged, the attendant increase in the interest burden initially complicated expenditure control, but that burden was quickly contained once the adjustment process was under way. With the public debt ratio soaring, interest payments more than tripled from less than 1 percent of GDP in the early 1980s to 3 percent of GDP in 1987/88. Also contributing to the rise in interest payments was an increase in the average interest rate on the public debt of 1/2-1 percentage point between the early and mid-1980s. This was despite a steady decrease in market interest rates for both the U.S. dollar and the Japanese yen, which are the two principal currency denominations of Indonesia's external public debt, and reflected primarily the Government's increasing reliance on nonconcessional financing in the face of a limited supply of concessional funds. The Government's interest bill leveled off in 1988/89 and fell thereafter, as the public debt ratio began to decline and reliance on nonconcessional financing was curtailed. By 1992/93, interest payments had declined by 1 percentage point of GDP from the 1988/89 peak.

The interest burden is a good indicator of the legacy of past fiscal policy. In the case of Indonesia, the legacy of the past decade's fiscal imbalances is an increase in the Government's interest bill by 1 percentage point of GDP. Without this added burden, the tax ratio could now be correspondingly lower for any given level of expenditure, thereby alleviating tax-induced distortions. Given the size of the oil counter-shock and of the adjustment effort already undertaken, it appears reasonable to accept the temporary shifting of some of the burden of adjustment from the 1980s to the 1990s. By the same token, however, it would seem that the process of adjustment still has some way to go. Even abstracting from the depletion of oil wealth, it would be necessary to

extend the effort to lower the public debt ratio at least over the medium term in order to revert to the Government's financial position of the early 1980s.

IV. Lessons from Past Experience and Future Policy Challenges

1. Medium-term objectives

The Indonesian experience suggests that to seek to stabilize the public debt ratio over the medium term may be insufficiently ambitious. A stable debt ratio would, in principle, ensure that the fiscal position is sustainable. But in the real world, that ratio is hardly ever stable. The speed with which debt can surge in times of adverse developments would indicate the need for rapid declines in more prosperous times. Alternatively, there is a risk that the debt burden will ratchet up to ever higher levels.

For the period ahead, a prudent medium-term objective for Indonesia would be to complete the process of adjustment set in motion by the oil counter-shock of the mid-1980s, by scaling back the public debt ratio, and the associated interest burden, to levels closer to those of the early 1980s. This would require a marked strengthening of the fiscal position. A stronger fiscal effort would also help maintain external balance as the role of private investment continues to expand, and it would serve to narrow the oil-adjusted deficit in anticipation of the depletion of oil wealth, thereby reassuring markets that the fiscal position will remain viable over the long run. Given the continued needs for public investment in human and physical capital, and the limited scope for further saving in current expenditure, a good part of the adjustment would probably have to come from increased revenue.

2. Tax policy

The sustained expansion of non-oil/gas tax receipts, which is perhaps the most conspicuous success of Indonesia's fiscal effort, points to some of the elements of successful tax reform. Low tax rates, with limited dispersion, help contain tax-induced distortions, while simultaneously

fostering improved tax compliance. The credibility and effectiveness of tax administration is also enhanced by starting small, with a narrowly defined and easy-to-locate tax base. This allows the authorities to ensure that enforcement remains manageable. The tax base can be subsequently expanded in line with administrative and enforcement capabilities. Although this may make tax reform an extended process, the end result is likely to be a more effective, broader, and better-enforced tax system.

In the period ahead, efforts to improve tax enforcement and compliance could be intensified, so as to tap a growing share of the potential tax base. As real incomes continue to rise and manufacturing continues to attract labor from the rural sector, there is also scope for a continuing expansion of the potential tax base over the medium term. Sustaining the pace of deregulation of trade and maintaining a competitive exchange rate, together with renewed efforts to strengthen customs administration, could also help consolidate earlier gains in the taxation of international trade. These efforts could make it possible for Indonesia to narrow and, ultimately, eliminate the gap between its non-oil/gas tax ratio and those of other ASEAN members.

3. Expenditure control

The Indonesian experience shows that government expenditure can be effectively controlled without permanently undermining essential public investment. Development expenditure did suffer sharp cuts in times of urgent adjustment, but it was allowed to recover as other revenue-enhancing and expenditure-reducing measures registered success. Although development expenditure has yet to return to the elevated levels of the mid-1980s, booming private investment has, in recent years, helped support rapid economic growth.

The progress to date in curbing current expenditure, together with the continuing needs for investment in the areas of infrastructure and education, may make it hard to further compress the aggregate expenditure ratio over the medium term. The adjustment effort could still be supported, however, by discipline in public wages and civil service employment, additional cuts in subsidies

and, as the public debt ratio declines, saving on interest payments. But the greatest risks for expenditure growth are probably in the field of development expenditure, an area in which demands and aspirations may be highest.

4. Public debt management

Indonesia stands out among countries with a similar burden of external debt for its exemplary debt-servicing record. A successful mix of prudent macroeconomic policies and market-oriented reforms is undoubtedly a key factor behind this achievement. Also important, however, has been a debt management policy that has generally emphasized borrowing primarily through official channels, at concessional rates, and with long repayment periods. As a result, dependence on commercial creditors has been kept in check, the flow of new financing has remained orderly, and the Government's interest burden has been restrained.

The increasing weight of external borrowing by the private sector would seem to call for continued caution in public debt management in the period ahead. The Government's amortization payments have increased steadily in recent years, while new official flows and commitments secured through the Indonesia Consultative Group of donors have levelled off. Indeed, it would probably be unrealistic to expect any substantial increase in aid flows to Indonesia at a time of increasing needs in poorer emerging economies. In these circumstances, it would seem sensible to target no net inflow of external loans to the Government in the short run and a gradual reduction in the stock of external public debt over the medium term.

5. Rules versus discretion

The operation of the balanced budget rule highlights some of the limitations and merits of policy rules. A rule that is devised to deal with a particular challenge may not be strictly appropriate in changed circumstances, but it may help steer discretionary actions in the right direction. While the balanced budget rule was not conducive to fiscal discipline during Indonesia's oil boom, it fostered rapid adjustment following the collapse of oil prices and helped create a policy

environment in which prudence usually prevailed. The recent shift toward a more transparent use of discretionary policy is welcome. Given the large stock of government deposits with Bank Indonesia, however, the scope for domestic financing of the budget deficit is more extensive now that the right to tap development budget reserves is officially acknowledged.

A more flexible interpretation of the balanced budget rule need not contravene the spirit of a balanced budget over the medium term. Continuation of a cautious public debt management policy, as suggested above, would help preclude any extensive deficit financing through external borrowing. However, with recourse to drawdowns of government deposits with Bank Indonesia being tantamount to domestic financing, to ensure fiscal stability, such financing would need to be measured, reserved for exceptional circumstances, and offset, over the medium term, by new deposits to development budget reserves. The disruptive short-run effects of future oil price cycles, in particular, could be mitigated by aiming for a stronger-than-budgeted fiscal position in times of unanticipated oil price increases as needed to build-up reserves for future periods of unexpectedly weak oil prices.

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