SHARING FISCAL BURDEN

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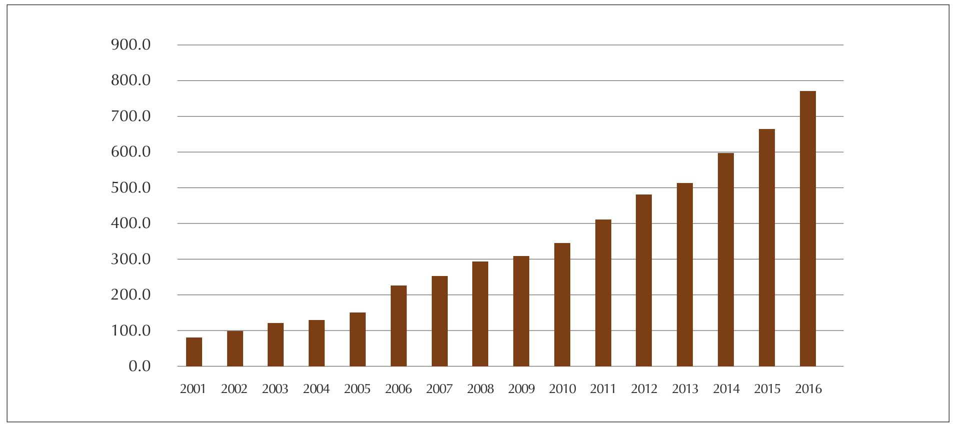
This policy brief is the result of an activity entitled "Economic Policymaking in Indonesia' which is jointly conducted by Centre for Strategic and International Studies (CSIS) and Economic Research Institute for ASEAN and East Asia (ERIA). This activity is a contribution from research community that is expected to assist the government in formulating more effective economic policies in the future. In this activity, CSIS and ERIA invited 16 economists with specific fields of expertise from some leading research institutions to conduct in-depth discussions on seven strategic issues facing Indonesian economy (infrastructure development, competitiveness, investment climate, food policy, services sector policy, fiscal policy, and social protection policy), which is then summarized into policy briefs covering each of the topics.

Dissemination of the findings and recommendations produced by this activity is conducted through several channels. First, this activity has made efforts to engage the relevant government officials through some Focus Group Discussions (FGD), the publication of High Level Policy Notes, and hearings with some strategic policymakers with regard to each of the strategic issues mentioned above. Secondly, this activity also conducts widespread public disseminations through Public Seminars on each of the strategic issues, along with publications of the Policy Briefs and supporting multimedia that can be accessed online through www.paradigmaekonomi.org.

ONE OF THE main agendas of the Jokowi-JK Government is to "*build Indonesia from the periphery in order to strengthen regions and villages within the framework of the Unitary State*". This can be done through an increase in the fund transfers towards the outer regions, districts and villages. The amount of transfer funds to the local governments and village government in the 2015 Revised State Budget has increased sharply. Rural funds for 2016 even increased by 125% in the state budget 2016, and will probably increase steadily until 2019.

Figure 1. Government Transfers to Regions & Villages, 2001-2016 (in IDR trillion)



However, the increase in funds transfers for regions and villages in recent years, as shown by **Figure 1** above, raises the question: to what extent is this policy in line with the fiscal needs of the local government? It is clear that there is a need for more government spending. They need to fund massive infrastructure projects, which will cost approximately Rp. 5500 trillion for the five years. With regards to health spending, Clements (2012) estimates that this spending in emerging economies will increase 1% of GDP within the next twenty years. Equally important, state expenditure for social safety net programs is also expected to increase in the future. Handra and Dita (2015) estimates that the fiscal burden of the pension system in Indonesia will reach about 1% of GDP in 2030 if the government should continue to pay the pensions of civil servants and are obliged to pay pension premiums of the poor.

The scarce resources to finance the infrastructure projects mean that a fair and efficient distribution of the fiscal burden is critical. This paper analyzes the condition of sharing fiscal burdens between different levels of government and proposes alternative policies are in favor of equality and fairness.

CAPACITY DISTRIBUTION AND FISCAL BURDEN BETWEEN GOVERNMENTS

In Indonesia, fiscal burden for the provision of public goods and services is a main responsibility for the government. The new laws of the local governments (UUPDB) determines the particular affairs handed over to the local governments, which can be seen as a process of decentralization. Consequently, local governments are responsible for financing decentralization affairs, as sources of their income is submitted in the Tax Act. But the tax levies is not sufficient to fund local tasks, as it is necessary to receive fund transfers from the central government.

Analyses of the financial state of Indonesia and financial relations between the central and regional sectors have created the following phenomenon;

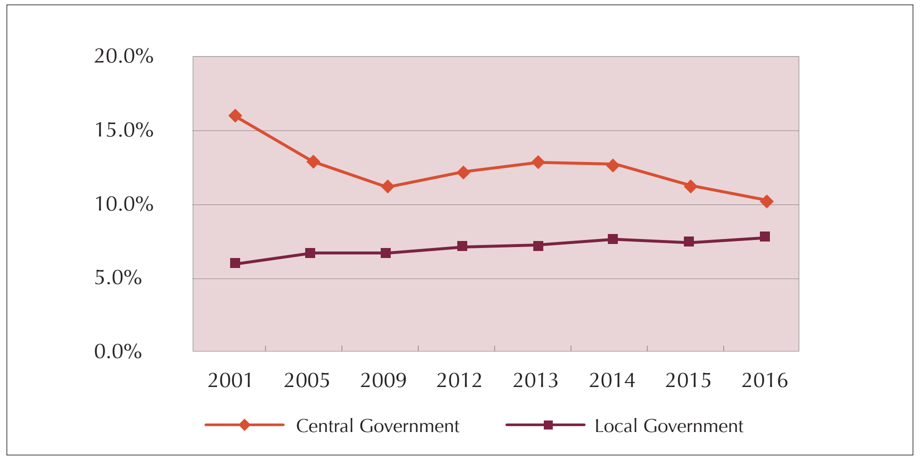
1. Transfer funds to regions tend to increase from yearly not only in nominal terms, but even as a percentage of GDP (see **Table 1**). Since 2010, there is even greater after the village funds program started in 2015.

Table 1. Government Spending & Revenue, 2001-2016 (% of GDP)

Tahun	Government Revenue			Government Expenditure			Defisit
	Tax	Non Tax	Total	Central Government	Transfer to Regions	Total	
2001	11.3%	7.0%	18.3%	15.8%	4.9%	20.7%	-2.5%
2002	11.5%	4.9%	16.4%	12.3%	5.4%	17.7%	-1.3%
2003	12.0%	4.9%	16.9%	12.7%	6.0%	18.7%	-1.7%
2004	12.2%	5.3%	17.6%	13.0%	5.7%	18.6%	-1.0%
2005	12.5%	5.3%	17.8%	13.0%	5.4%	18.4%	-0.5%
2006	12.3%	6.8%	19.1%	13.2%	6.8%	20.0%	-0.9%
2007	12.4%	5.4%	17.8%	12.7%	6.4%	19.1%	-1.3%
2008	13.3%	6.5%	19.8%	14.0%	5.9%	19.9%	-0.1%
2009	11.0%	4.0%	15.1%	11.2%	5.5%	16.7%	-1.6%
2010	11.2%	4.2%	15.4%	12.1%	5.3%	17.5%	-0.7%
2011	11.8%	4.5%	16.2%	11.9%	5.5%	17.4%	-2.1%
2012	11.9%	4.3%	16.2%	12.3%	5.8%	18.1%	-1.9%
2013	11.6%	3.8%	15.4%	12.9%	5.5%	18.4%	-2.4%
2014	12.7%	3.8%	16.6%	12.7%	5.9%	18.7%	-2.4%
2015	12.7%	2.3%	15.0%	11.3%	5.7%	16.9%	-1.9%
2016	12.0%	2.2%	14.2%	10.3%	6.0%	16.3%	-2.%

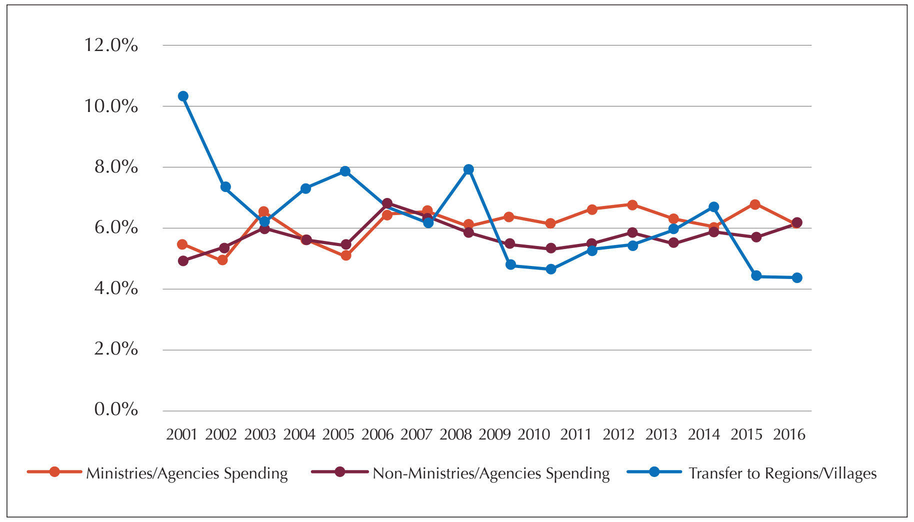
2. Main government expenditure tends to decrease when the state revenue fall as a percentage of GDP, while transfer funds to rural areas increase. The government chose to maintain the deficit at an average of 2% of GDP, although financial laws (UU 17 of 2003) allow a deficit of 3% of GDP. The decline in revenue, especially since 2006, is primarily caused by the decrease in non-tax revenue. The decline in state revenue should be somewhat hindered if the government is able to increase tax revenue. However, tax revenues have stagnated during SBY's tenure. Since 2009, the government prefers to cut spending by lowering the fund transfers to the regions as a response to the declining in state revenue.
3. Increasing expenditures of local governments, specifically provincial, district and city, confirms the growing magnitude of the funds managed by them. Local sources of revenue (PAD) and main funds transfer have increased from yearly. PAD has increased sharply from 1.2% of GDP in 2009 to 1.7% of GDP in 2013. This occurs because of the transferring taxes to rural areas under Law No. 28 of 2009. Coupled with the transfer of funds from the central government, local government expenditure is estimated at around 7.4% of GDP and increased to 7.7% of GDP in 2016 (see **Figure 2**). This quantity is much greater than it would be in 2005, approximately 6.7% of GDP.

Figure 2. Central and Local Government Spending (% of GDP)



4. A decrease in central government expenditure is clearly apparent. In 2005, government spending stood at 13% of GDP, but falls to level of 10.3% of GDP, in 2016. The decline in government spending, relative to GDP, is reflected in ministry expenditures, which is also called K/L ratio. Specifically, K/L is the expenditure that is used directly by ministries for operation, maintenance and development purposes. From 2003 to 2015, K/L expenditure stagnated, while there more fluctuations in Non K / L expenditures (see **Figure 3**).

Figure 3. The Composition of Government Spending, 2001-2016 (as % of GDP)



5. A decrease in ministries spending is somewhat alarming since ministries have the responsibility to serve the community and facilitate the activities of the national economy. Moreover, the burden of central government expenditure for social security programs, both in the short term and long term, are very important. Likewise, the burden of non-ministry expenditure is a pressing issue, especially pertaining to energy subsidies. Pressure to subsidize brought from energy was alleviated, due to a decline in oil and gas prices in 2015. However, this is unsustainable especially if government does not make any immediate price adjustments.
6. An increase in rural expenditure was not followed by additional fiscal burden in terms of expenditure assignment. Since 2001, under UU 22/1999 and UU 23/2014, there were no significant changes related matters submitted local governments. An increase in the fund transfers to the rural areas is somewhat unnecessary. Even if the increase in nominal terms is caused by an increase in state revenue, the proportion towards total state expenditure should still be kept. The policy to increase in transfer funds to rural areas may be considered appropriate in case of an additional assignment to the area. The laws pertaining to regional governments, specifically UU No. 23 of 2014, does not provide the additional assignments towards them.
7. Internal and external pressures that could decrease the state budget was also apparent in 2015 with the implementation of Law No. 6 of 2014. Village funds emerged as a response to the political promises of "*one billion, one village*". Assignments towards villages are similar to previous assignments under Law No. 32 of 2004. That is, the implementation the villages' funds can potentially increase state expenditure. Village funds started at Rp. 20.8 Trillion in early 2015, but then increased dramatically, specifically 125%, in 2016 and will continue to increase until 2019 (see **Table 2**).

Table 2. The Amount of Village Funds, 2015-2019 (in IDR trillion)

	2015	2016	2017	2018	2019
Amount of village funds (from central government)	20.8	47	81.2	103.8	111.8
Allocation of Regional Balance Funding (regencies/cities)	34.2	37.6	42.2	55.9	60.3
Revenue Sharing Fund of Genuine Local Revenue (PAD) of regencies/cities	4.1	4.3	4.9	5.7	6.4
Estimated amount of funds under villages' management	59.1	88.9	128.3	165.4	178.5

TRANSFERRING GOVERNMENT FISCAL BURDEN TOWARDS REGIONS AND VILLAGES

From the foregoing description it appears that the central government needs to share fiscal burdens to the regional areas and villages. Two important things that need to be done by government are to provide additional assignment to local and village governments and anticipate the potential additional fiscal burden of future expenditures primarily relating to social security programs.

Additional assignment to local governments shared between the center and regions are education, health, public works and cross-sectorial fields such as social security programs. In terms of legal as well defense and security sectors, the central government handles the responsibility of the fiscal burden for these sectors.

To look at prospect of the regional government adding assignments or projects pertaining to education, health and public works, there is a need to analyze division of affairs. In general, it can be described as follows:

1. In terms of education, there has been quite clear division of tasks appropriate level of education. Fundraising higher education remains a responsibility of the government, while early childhood education (ECD), primary and secondary education, non-formal is in the hands regional governments. However, the central government has a broad authority to determine national standards, national curriculum, and accreditation of educational institutions at all levels of education.

2. For the health sector, the division of tasks is also quite clear. For the implementation of the Individual Health Effort (UKP) and Public Health Effort (UKM), the distinction lies in the service scale. If the services are provided at the district or city and inter-district or city in the province, then the responsibility is in the hands of regional governments. While the central government has responsibility for national or cross-province referrals. In addition, the central government will have broad responsibilities associated with the recruitment of health workers in the region, the availability of drugs, vaccines, medical devices, as well as supervision of food and beverages.
3. There is also a clear division in terms of public activities. There are no classification of roads, district, provincial and national roads. Hence they're funding schemes are different. For irrigation, housing and settlement, however, the role of central government tends to be more important.

Fiscal burden arising from the health sector, specifically food and drug supervision, can be delegated from regional government towards provinces. In terms of education, local governments should be encouraged to set up a unit of vocational education and training institutions of skilled labor. Local governments are responsible for public work, because the working conditions are still far below the minimum standards.

For national social security programs, governments need to anticipate the potential of additional fiscal burden in the future. Dividing the fiscal burden to the regional governments as well as to the village, with the increase in the village funds, can achieve this. Dividing the fiscal burden among levels of government is basically services distribute the funding risk. If there was no division in the first place the central government will lose state revenue. However, if the burden is shared, then the risk of financing will also be distributed among the different parties.

Most of the fiscal risks will be in the hands of the national government. But dividing the fiscal burdens or expenditure responsibilities to local governments even villages, mainly to fund the functions that have been devolved will increase the accountability of local and rural governments to provide better local public services and participate in national social security program.

CONCLUSIONS AND RECOMMENDATIONS

It can be concluded that the various policies to raise funds transfers to regional and village are under pressure because they do not increase proportionately in line with GDP growth. The government has put pressure resulting in declining fiscal expenditure. In addition, it is expected that they will face increasing expenditure to maintain and improve the quality of infrastructure and social security expenditures.

For that the transfers to regional and village areas has to maintained at a certain level without sacrificing local public services and regional development. However, because the government is required to increase the funds transfer, dividing the fiscal expenditure responsibilities to regional and village should be immediately followed.

Aside from an increased funds transfer, there are also some alternatives that may be implemented to share the fiscal burden:

1. Sharing the fiscal burden of public pensions funds between central and regional governments. The government needs to change the pension system of civil servants' pay as you go (PAYGO), which is also called "system to" fully funded ". With the PAYGO system, the government is responsible to pay the pensions of civil servants after retirement to the widower or widow pensioners. With a fully funded system, the government only pays pensions to those civil servants worked, and they would receive such pension savings when they retire.
2. Fully funded system allows sharing the burden of the pension fund with the local governments and villages. Local government and village must take the responsibility to pay the regional civil servants pension fund. This system may be applicable to the newly appointed civil servants. In other words, for them, the government or local governments that employ civil servants should pay pension contributions to the civil servants BPJS Employment. It will reduce fiscal burden sharing for pension contributions between the central and local governments. The government will be paying additional pension contributions of civil servants center, while local government will be paying additional pension contributions of civil servants regions. With regards to civil servants pension, BPJS is fully responsible for paying the pension corresponding contributions. If this alternative could be done, the fiscal burden of the state budget for direct payments to retirees will be gradually reduced.
3. The village authorities are expected to receive the growing transfer funds It is estimated that by 2019, every village government will accept the transfer of at least Rp. 2.2 billion (Roadmap Village Fund, Ministry of Finance). However, assignments to the village government are neither detailed nor complete. One assignment that may be given to the village government is paying part of health insurance low-income families, which is already partially paid by the central government and villages. This system would encourage the village officials to participate in programs to tackle poverty. During this time, they tend to propose as many people who get health insurance, and there is the possibility of manipulation of data for the determination of poor citizens.
4. The government needs to provide broader access for local governments to finance, or specifically borrow the area or to issue municipal bonds to fund the development of local infrastructure, which encourages the growth of the area. Providing access to financing (loans and bonds) for local governments will encourage increased accountability than with providing additional funds transfer (special assistance) for infrastructure development. Provision of continuously increasing grants tend to spoil the local government and will fiscally pressure the government on the conditions of economic slowdown.

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