Inside Indonesia

On Firmer Ground
Indonesia builds its 2017 budget on realistic assumptions

Aug 16, 2016

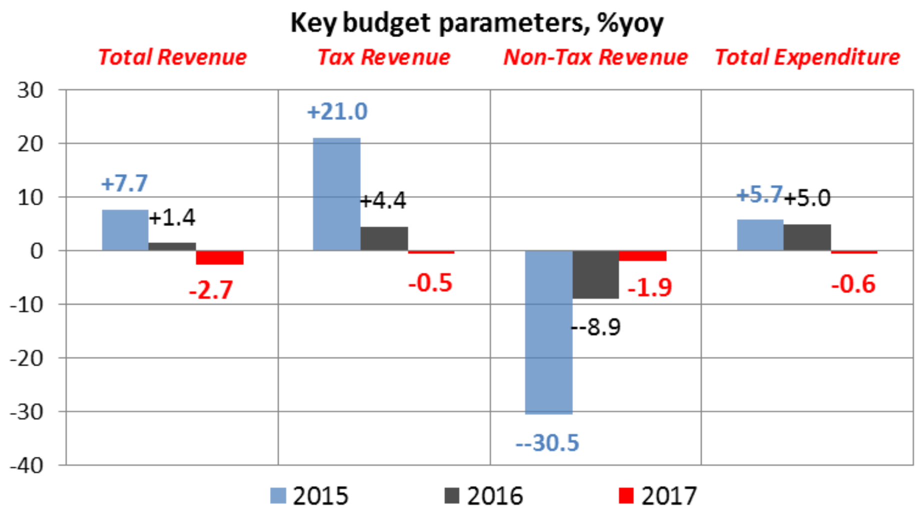
- **One day shy of turning 71, Indonesia just heard its president sketch out the government budget for 2017. Grounded in reality, the set of numbers have the new finance minister's pragmatism imbued all over it.**
- **On the macro assumptions front, growth of 5.3% is largely within reach next year, for instance. Overall budget deficit is to be 2.4%, an achievable narrowing from this year's 2.5% of GDP.**
- **Contraction is projected across both revenue and expenditure. In particular, 0.5% shrinkage is seen in tax revenue, which suggests a building in of lower tax rates, even as tax base should broaden post-amnesty.**

Out of Comfort Zone

Today appears to have been an especially busy day for President Jokowi. Before he delivered the 2017 budget speech to Indonesia's parliament this afternoon, he gave his spiel in the State of the Nation address hours before.

In it, besides a spirited pronouncement on how the government will develop "every inch" of Indonesia's vast territory – including the far-flung Natuna island where it had some geopolitical brushes against China recently – Jokowi spoke more broadly about how his countrymen should have the courage to leave their comfort zones to overcome challenges.

In the budget tabled thereafter, the president seems to do precisely that. Perhaps to show that he is at the forefront of being rid of the old ways and adopting new thinking, the top-line fiscal figures indicate an unusual year-on-year contraction in expected revenue and expenditure for 2017.



Source: Bloomberg, CEIC, OCBC.

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Tel: 6349-1886

Wellian Wiranto
Economist
Treasury Research & Strategy,
Global Treasury,
OCBC Bank

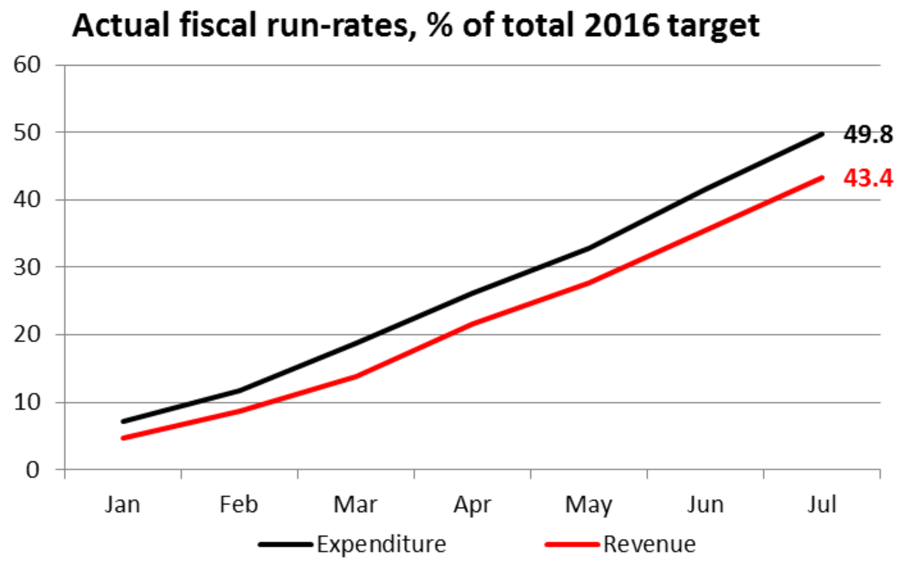
+65 6530-5949
wellianwiranto@ocbc.com

Take the projected expenditure, for instance. Although relatively mild at 0.6% yoy contraction, this marks the first time that an Indonesian government is expecting to spend less compared to the year before, since 2012. This compares with a 5.0% increase when we look at the current 2016 budget versus 2015. Things would be even more out of comfort zone, when we zoom in onto the revenue side of things. Total revenue for 2017 is budgeted to be 2.7% lower than the government take this year, compared to 1.4% and 7.7% yoy increases of the previous two years.

Why these sudden drops?

First of all, such contractions in both revenue and expenditure that are expected to take place next year have to be seen in the context of this year's projected figures. Because there is a high chance that 2016 full-year numbers will not be achieved on both fronts to begin with, then the degree of would-be contraction in 2017 will automatically be less pronounced.

In terms of the run rate of Indonesia's fiscal numbers, the last figures we have are as of August 5th. Expenditure stands at just short of 50% of its full-year target, while revenue take is but 43.4% of its full-year 2016 projected print. For tax-based revenue, in particular, the run-rate is at just 40%. Such things do not go up in straight line, of course. However, if they do, we should be a lot closer to 60% - which is how many days of the year have passed us by.



Source: Ministry of Finance, OCBC.
Note: The 'July' figures are actually numbers as of August 5th, to be precise.

Aside from such base-effect considerations, the fact that the figures tabled today in the 2017 budget are lower is also heavily predicated on more realistic assumptions.

It has become a norm by now that budgets will typically be tabled using fairly high growth assumption, only to be recast lower soon after. Given that this is one of the key variables influencing actual government revenue in particular – as higher economic growth brings more revenue via Value Added Tax, etc. – then any downside 'surprise' in growth assumption would naturally lead to shortfall in revenue.

Key Macro Assumptions	2015	2016
Economic Growth (%)	5.2	5.3
Inflation (%)	4.0	4.0
Exchange Rate (Rp/USD)	13500	13300
3-Month Government Treasury Bills (%)	5.5	5.3
Crude Oil Price (USD/barrel)	40	45
Oil Lifting (Thousand barrels/day)	820	780
Gas Lifting (Thousand barrels/day equal to oil)	1150	1150

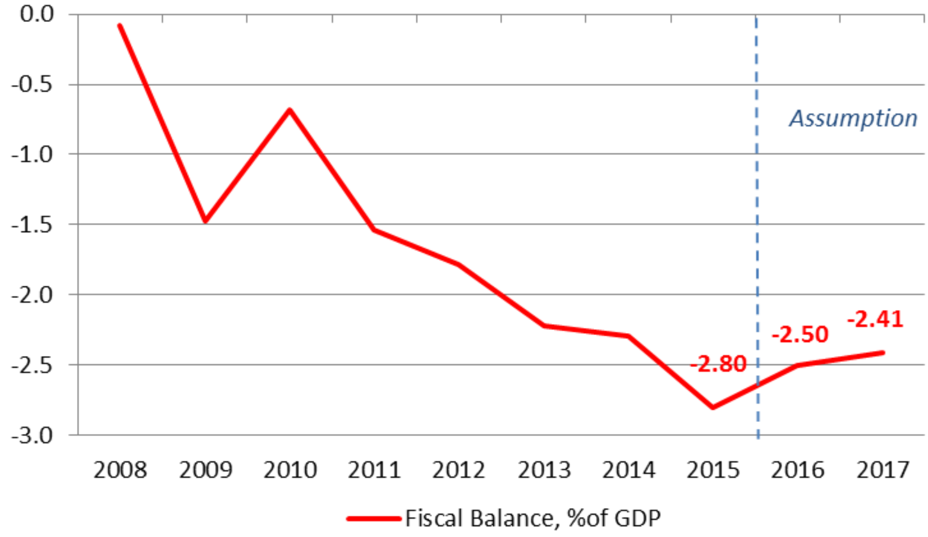
Source: Finance Ministry, OCBC.

It is heartening then, that the 5.3% yoy growth expected next year looks largely achievable. In other words, even as the potential year-on-year contraction in revenue might be slightly disconcerting, the fact that whatever number has been pencilled in is a lot more realistic now should be a point of comfort for investors to begin with.

The same story goes for other macroeconomic assumptions in the latest budget. Notably, oil lifting – which is basically how much oil Indonesia's creaking production could eke out – is now expected to be 780k barrels per day, lower and eminently more realistic than the numbers put out previously. This new sense of realism bears the fingerprints of Sri Mulyani, the new Finance Minister. Presumably, having spent the previous 5 years leading a bureaucratic behemoth that is the World Bank, she understands the benefits of under-promising and over-delivering.

Here, having set the expectation at sensible levels, a potential upside surprise might in fact be had in terms of tax revenue next year. This bucket is projected to shrink by 0.5% to yield the government IDR1.496tn (~USD112.5bn) next year. Given that the ongoing Tax Amnesty program is supposed to broaden the base for taxable assets for the government – and also provide compliance tax at least in the first quarter of next year at the tail-end of its applicable period – the projected shrinkage may be slightly baffling. I believe that it does not mean that the government is expecting the Tax Amnesty to be a failure, but more of a function of reality (again) and also to build in potential cuts in tax rate. Even if the 'volume' of taxable assets should go up, the 'price' may come down and thus potentially put a dent on total revenue.

Already, various government officials have been busy talking about the prospect of decreases in tax rate. Jokowi himself spoke about the goal of cutting corporate tax rate from the current 25% to 17%, either in stages or one fell swoop, for example. This is pursued with the idea of matching the tax-rate attractiveness of neighbouring countries, so that fewer corporations will be tempted by creative ideas such as transfer pricing, for one. For good measure, the government has also been increasingly highlighting the potential of setting up onshore tax havens, at the idyllic islands of Rempang and Bintan – incidentally where I hail from. There is no exact timeline for these measures to take place, but they form the backbone of a legislative revision to Indonesia's tax code that will be high on the agenda for the government. And today's budget probably takes into account the potential of such changes taking place sometime next year.



Source: Finance Ministry, OCBC.

All in all, as Sri Mulyani said today following the release of budget details, she is keen on having a 'fiscal buffer' to cushion against various scenarios. The fact that deficit is expected to be 2.41% of GDP should leave some room of manoeuvre against the 3% legislative hard limit. With so many unknowns out there – including the potential for a global economic shock – the government would be wise to keep as much of such buffer as possible indeed.