Making Fiscal Rules Enforceable

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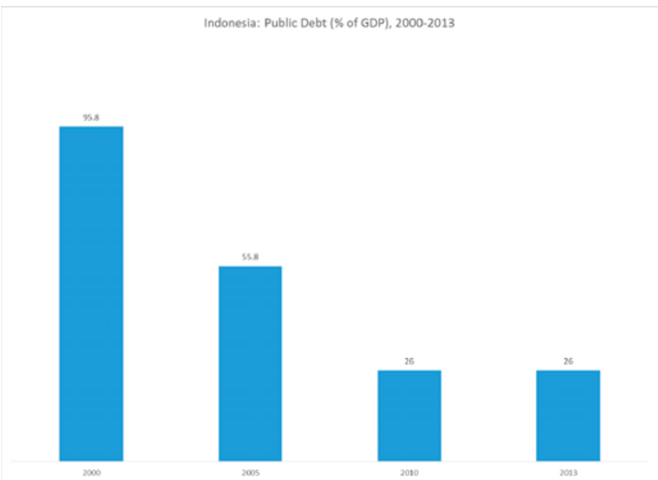
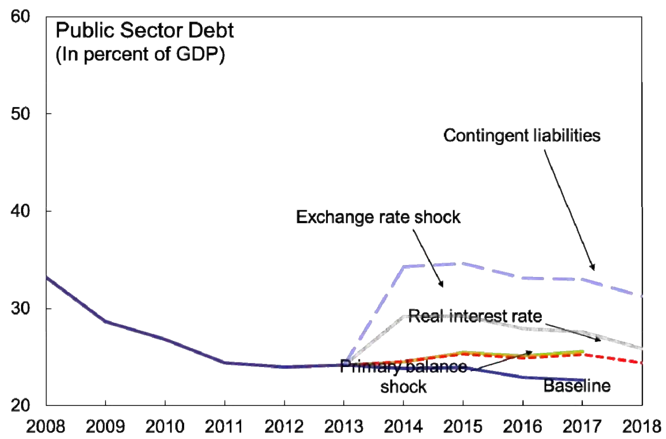
Agenda of Presentation

- Discuss fiscal rules and its relation to fiscal situation in Indonesia
- Answer question 1-4 (all are in the context of Indonesia's case}:
    - Question 1: What determine compliance with fiscal rules
    - Question 2 : What are prominent cases of the success and failures of fiscal rules in Indonesia
    - Question 3:What specific enforcement mechanism can be envisaged: automatic correction, formal sanction and informal sanction or reputational mechanism
    - Question 4: The role of Fiscal Council
- Discussion and Summary

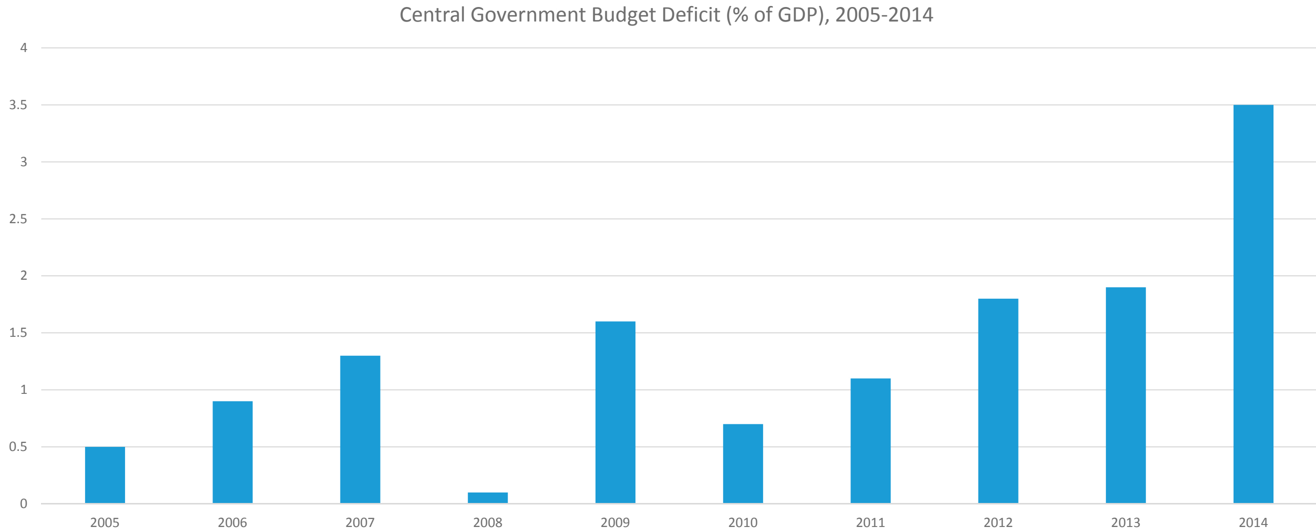
Type of National Rules (Start Date in Brackets)	Key Characteristics (start date in brackets if different from implementation)					
	Statutory Basis	Coverage	Formal Enforcement Procedures	Independent Body Sets Budget Assumptions	Independent Body Monitors Implementation	Well-Specified Escape Clauses
Debt Rule (2003)	Coalition Agreement	General Government	No, but binding by the law	No, but initial initiative was tried in the 2001-2003 period before this law implemented	No	No, Draft of Law on Financial Safety Net allow government to take any necessary action including breaking these fiscal rules during the crisis time
Balance Budget Rule (1967)	Coalition Agreement	General Government			No	
Local Borrowing limit	Coalition Agreement	Local Government	Not clear	No	No	No
Foreign Borrowing Approval for SOEs	Government Policy	SOEs	Yes	No	No	No
National Rules (date in brackets):						
DR (since 2004) : Total Central and Local Government debt should not exceed 60 percent of GDP						
BBR (since 1967): The consolidated national and local government budget deficit is limited to 3 % of GDP in any given year. Before 2004, BBR was set based on the principle that the budget deficit was not allowed to financed by domestic sources. However it could be financed by foreign loan.						
The rules are set out in the State Finance Law and Government Regulation 23/2204						
Source: Budina, Nina et.al (2012), Fiscal Rules at a Glance : Country Details from a Dataset and author's further elaboration						

Debt Rules: not an issue



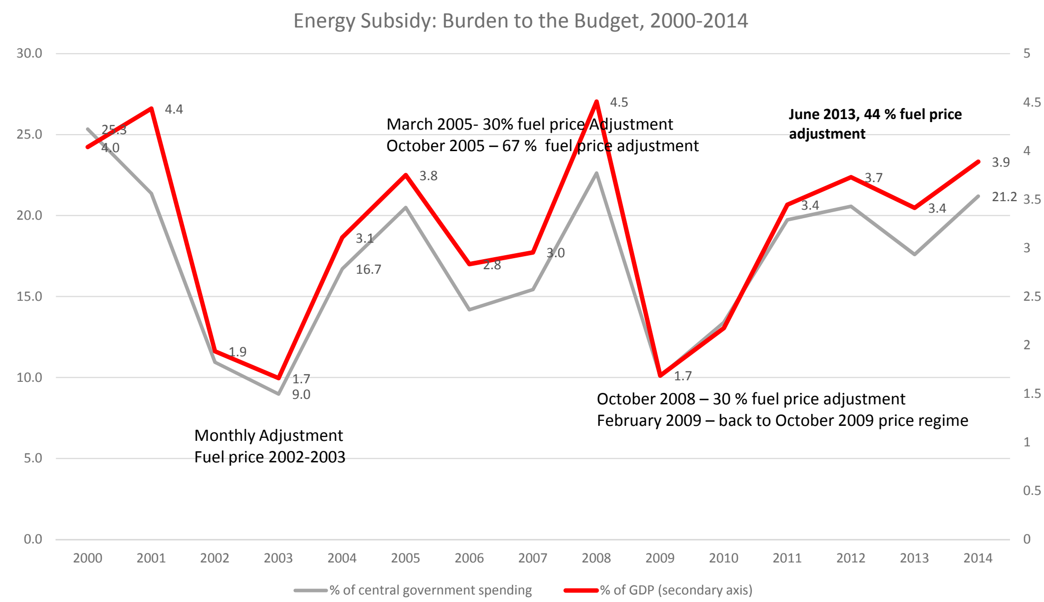


Deficit Rule also not an issue partly related to spending capacity



2014 is author projection without budget adjusment

Energy Subsidy in Indonesia: Burden to the Budget



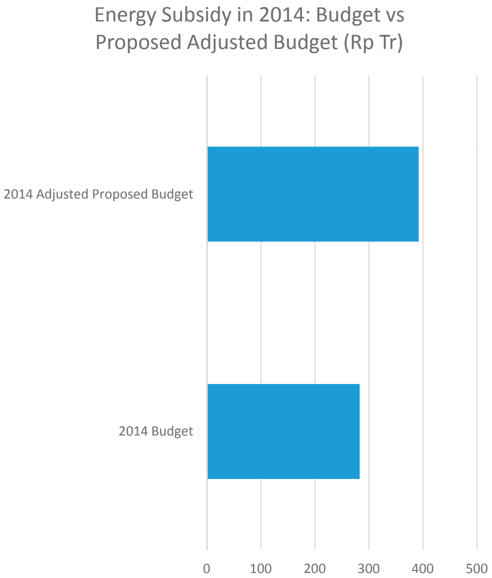
Question 1: What determine compliance with fiscal rules?

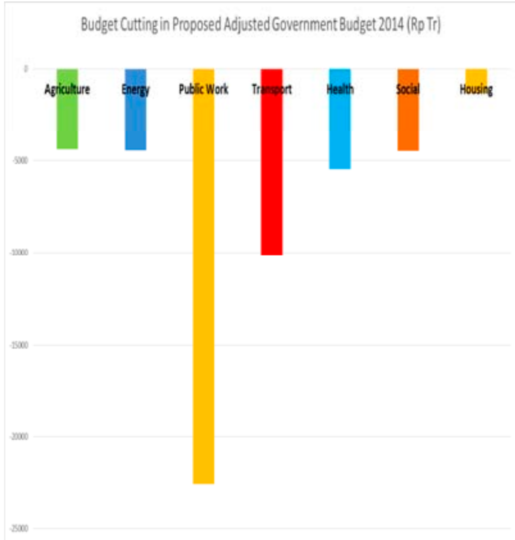
- As shown the previous slide, no explicit enforcement procedures for the case of Indonesia.
- However because it stated explicitly in the State Financial Law no 17/2003 [Debt limit less than 60% and overall deficit less than 3 % of GDP, any violation of the law will subject to **government impeachement**.
- Ministers and other policymakers at lower level are subject to criminal act for any violation(s) of the principles of this law.
- High rate of compliance is also associated to fiscal prudence culture that has been involved in all levels of government levels.

Question 2 : What are prominent cases of the success and failures of fiscal rules in Indonesia?

- Success cases
  - By limiting the deficit and hence primary balance surplus, public debt has been able to reduced significantly from 100 % of GDP in 2000 to xx % of GDP in 2004 [when the fiscal rules (debt level rule) applied] and continued to decline to xx % and the end 2013
  - Forced the top policymakers to take the bitter unpopular budget policy options [reduce the energy subsidies in 2005, 2008, 2013] and cut the spendings [2014]
  - Indonesia has been able to upgrade its rating the investment grade.
- Failures cases
  - Do not address the main problem of fiscal policy : problems in budget allocation and underspending for some important activities such as infrastructures and social spending.
  - Eventhough current literatures show that Indonesia's budget either acyclical (IMF, 2009) or counrcyclical [Budiarso (2011)] but the budget situation in 2014 is clearly procyclical. While the economy is slowing down, because GOI is not able to cut energy subsidy, the solution then cut the spending where mostly infrastructures.

Since the budget deficit limit at 3 % of GDP, an increasing the energy subsidy has cost other important sectors like infrastructure and health





Question 3:What specific enforcement mechanism can be envisaged: automatic correction, formal sanction and informal sanction or reputational mechanism?

- Automatic correction : never tested because our debt level well below the threshold
- Formal saction : from the experiences work relatively well – encourage and force the policy makers to adjust and to take a difficult policy choice.
- Reputational mechanism : it could be a reason of the good fiscal culture.

Question 4: The role of Fiscal Council

- We don't have fiscal council. The state financial law does not require to have a fiscal council.
- In the conceptual basis , the existence of fiscal council could be good to improve the effectiveness of government spending and fiscal policy for the economic performance.
    - Budget planning and projection is more accurate
    - Governance both in planning and implementation will be better
- But in the practice could be different.
  - Recruitment problem – instead of having a good and independent profesional to run the council, we may be ended up the other way around.
  - The council could then be problem than the solution.

Discussion

- Fiscal Rule is necessary but a country with low credibility like Indonesia.
- But not sufficient – not able to address other important issues
  - Problem in Budget allocation and sustainability of spending – the presence of huge energy subsidy and underspending in infrastructures and social spending.
  - Lack of flexibility of the allocation – limit the discreationary spending.
    - Education spending must be 20% of total spending
    - General Local transfer (DAU) = 26,5% of net domestic revenues [Domestic Revenues- Revenues Sharing – Energy Subsidy]
    - Village Law = 10% of Local Fiscal Transfer
    - Health (exclude salary) Law = 5% of Spending
  - Narrow revenue bases
  - Lack efficiency and quality on the implementation (timing, procurement)
  - Poor governance and weak fiscal institution
    - Power to much to the line minister and the parliament
    - Lack of technical knowledge at the ministry of finance
- No escape clause → important during the crisis time