BARRON'S ASIA
ASIA'S BEST MINDS

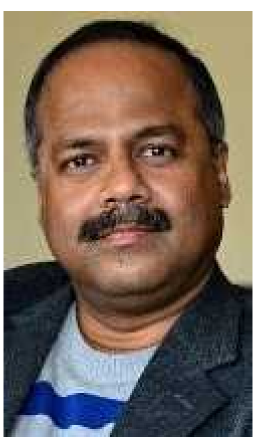
Double Trouble For Indonesia's Budget

Societe Generale's Kunal Kumar Kundu says lower tax revenue and a weak currency will worsen budget deficit.

By
KUNAL KUMAR KUNDU
April 8, 2015

The virtual elimination of the oil subsidy notwithstanding, Indonesia is staring at a much higher level of fiscal deficit than is currently being assumed (official estimate of 1.9% of GDP and SG estimate of 2.1% of GDP). We do not think the deficit will hit the legal limit of 3%, but it will likely print at 2.6% of GDP. We see multiple channels causing this overshoot – lower revenue (including the loss of revenue due to tax incentives) resurfacing of oil subsidy due to a weak IDR and lower GDP growth.

Indonesia's revised budget for 2015 contains some contentious assumptions. On the one hand it assumes lower GDP growth rate, and lower oil prices as compared to the original budget, but on the other hand, the assumption is of a fairly benign budget deficit engendered by an overly optimistic revenue growth expectation.



Unrealistic tax revenue expectation

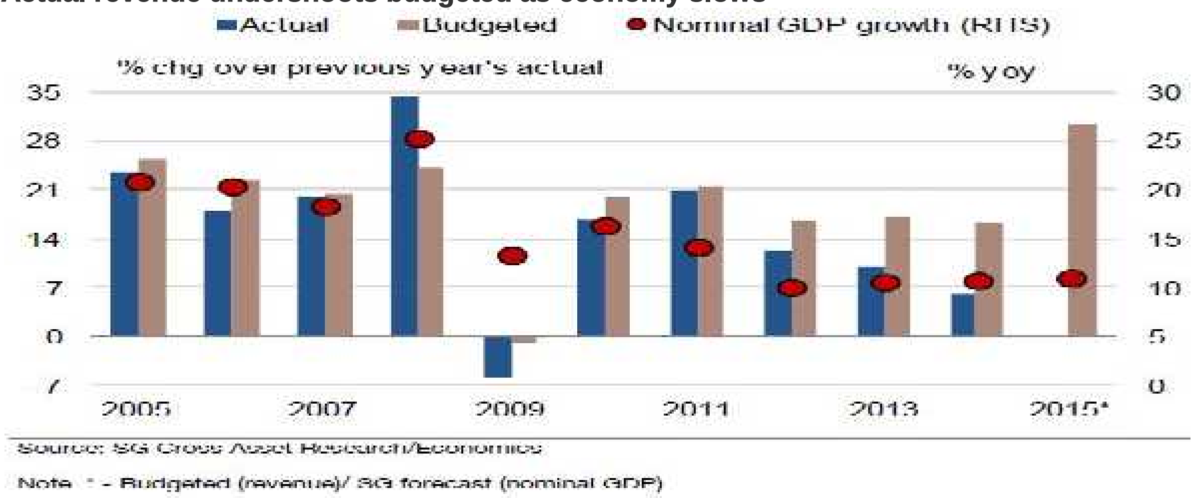
For 2015, the overall tax revenue is expected to grow by as much as 30% compared to the expected outrun in 2014, when it likely grew by a mere 6.1% - a significant 10% point lower than what was budgeted in 2014, and in keeping with the trend of continued undershooting of the tax revenue target.

In fact, except for 2008, Indonesia's tax revenue growth has always been lower than what was budgeted. Yet, the projected growth in tax revenue in 2015 is the highest ever.

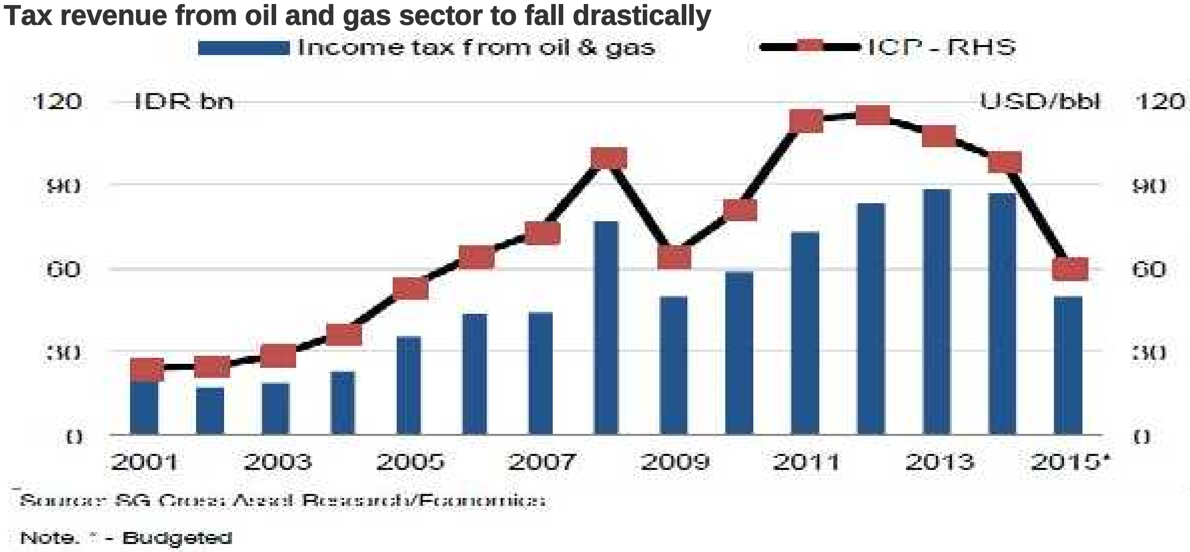
Surprisingly, for the 2015 budget, when every other assumption in the revised budget was downgraded from the original assumption, the tax revenue collection expectation increased by nearly 8% from IDR1280 trillion to IDR1489 trillion.

The decline in tax revenue in 2014 was due to commodity super cycle turning around and economic activity remaining weak. What is quite baffling is that, even after the government factored in lower (approximately 42%) income tax revenue from the oil and gas sector in the revised budget for 2015, as compared to the expected outrun in 2014, the overall income tax revenue is budgeted to grow at an unprecedented rate. This is because the factors that led to a lower tax revenue collection in 2014 are unlikely to change meaningfully in 2015.

Actual revenue undershoots budgeted as economy slows



Tax revenue from oil and gas sector to fall drastically



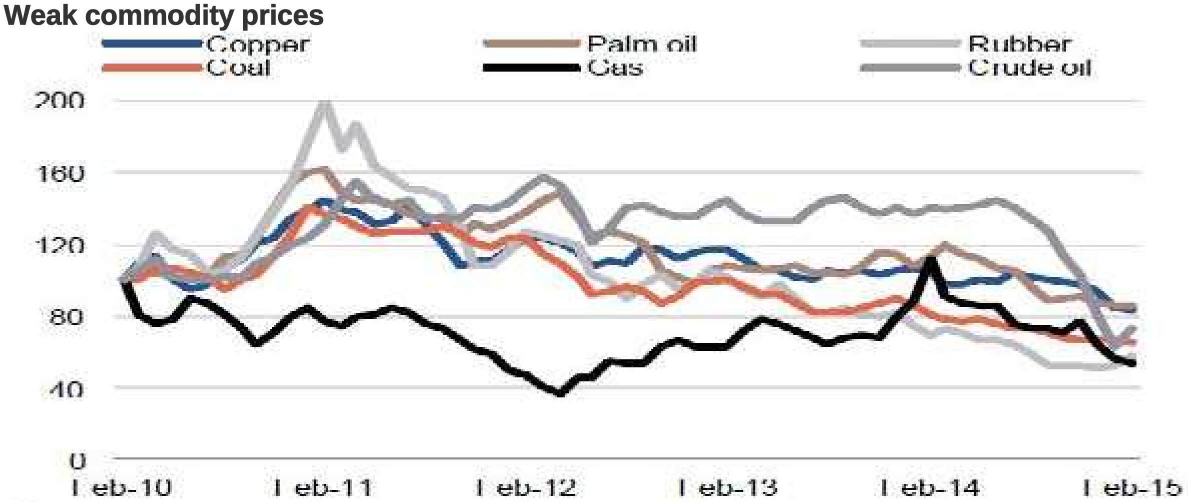
Moreover, in the current year, tax revenue collection would also be impacted due to the proposed tax incentive for investment. In fact, in an effort to jump start investment in the private sector, the government, starting in April will allow a 5% tax deduction in the corporate income tax per year for up to six years, depending on how much it has invested over that period. The regulation also includes lower income tax requirements for dividends.

The government, on its part, believes that improvements in tax administration can be made through increased efficiency in tax collection and better institutional collaboration. The government is also hoping that its proposed plans to prosecute large tax evaders, provide tax amnesty to unearth black money, increase mining royalty rates, introduce new taxes on new oil and gas production sharing contract holders and so forth will help raise tax revenue. However, we are much less convinced. Given that Indonesia has one of the lowest tax-to-GDP ratios among its peers, expecting a sudden spike in tax revenues within one year seems much too ambitious. A tax revenue increase of this magnitude from additional efforts in a single year is unprecedented and this target will be even more difficult to achieve due to low oil prices, weak commodity prices and a slowing economy.

Weakening currency to negate effect of weak oil prices on subsidy

Unlike India, Indonesia is not an unambiguous beneficiary of weak oil prices. While the country is expected to benefit to the tune of IDR230 trillion in oil subsidy savings, its loss in terms of tax and non-tax revenue from this sector will negate roughly around two-thirds of the gain. On the other hand, with the currency on a weakening spree (along with the recent spurt in oil prices due to the evolving geopolitical situation), retail prices of subsidized fuel are already below the market price. Recently, the government increased the prices of gasoline (to IDR7,400 per liter) and diesel (to IDR6,900 per liter) by IDR500 per liter respectively. Yet, prices of subsidized fuels are quite lower than the market price.

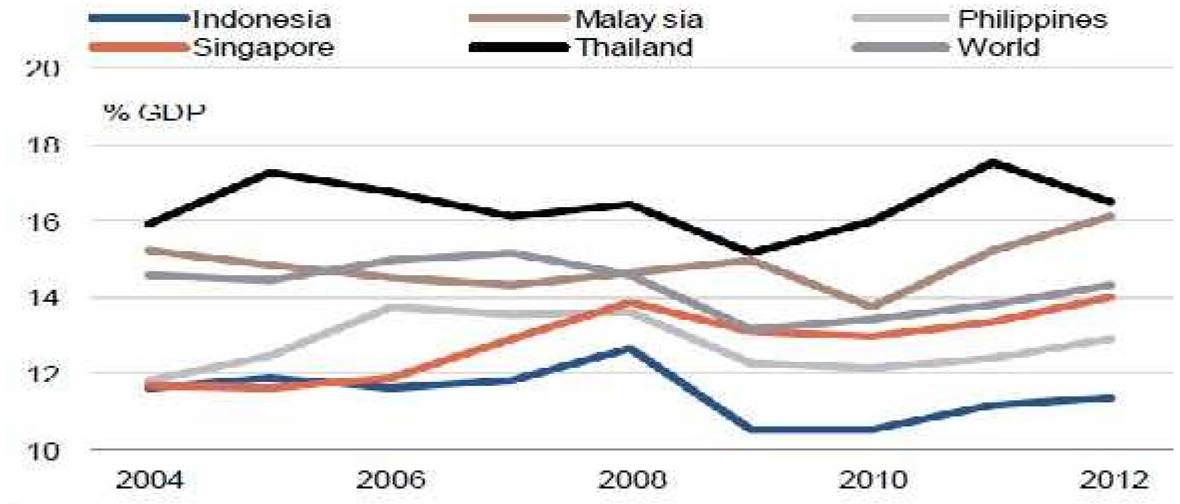
Weak commodity prices



Source: World Bank; SG Cross Asset Research/Economics

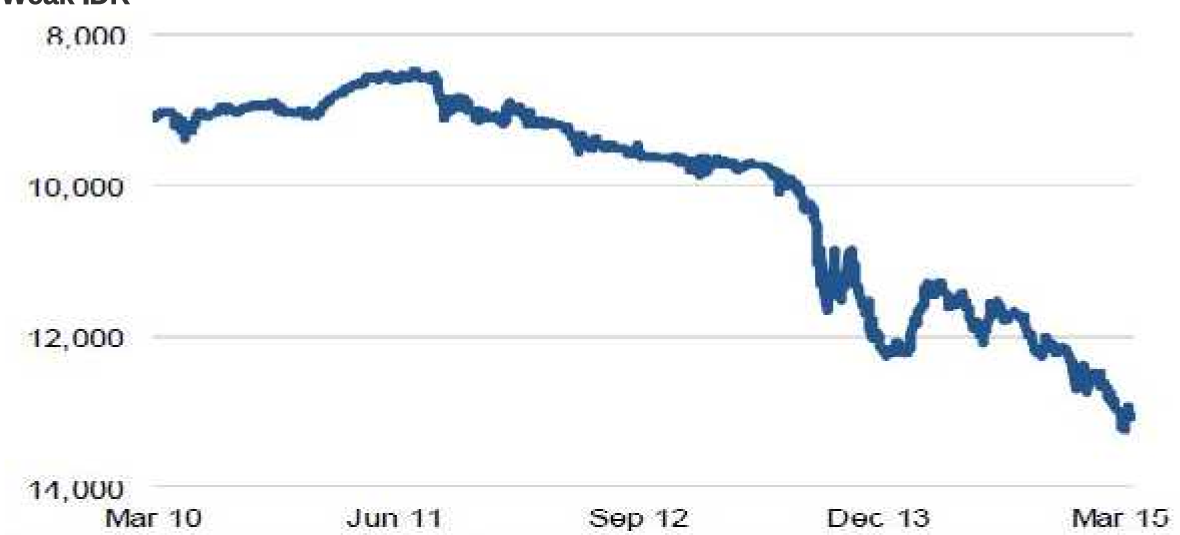
Under the new fixed-subsidy system, the prices of gasoline and diesel are no longer capped, but instead are evaluated and adjusted every month in accordance with the fluctuations in the exchange rate and global oil prices. However, the government has preferred to keep the hike at modest levels so as not to burden consumers. To an extent, this also means that the government is doing a flip flop with regard to the subsidy policy that was announced with much fanfare. While the government has temporarily asked the state-owned oil and gas company Pertamina to finance the gap, it may eventually have to take on this burden if the price differential persists and the government does not want to pass on the higher costs.

Indonesia - Unfavourable tax-to-GDP ratio



Source: World Bank; SG Cross Asset Research/Economics

Weak IDR



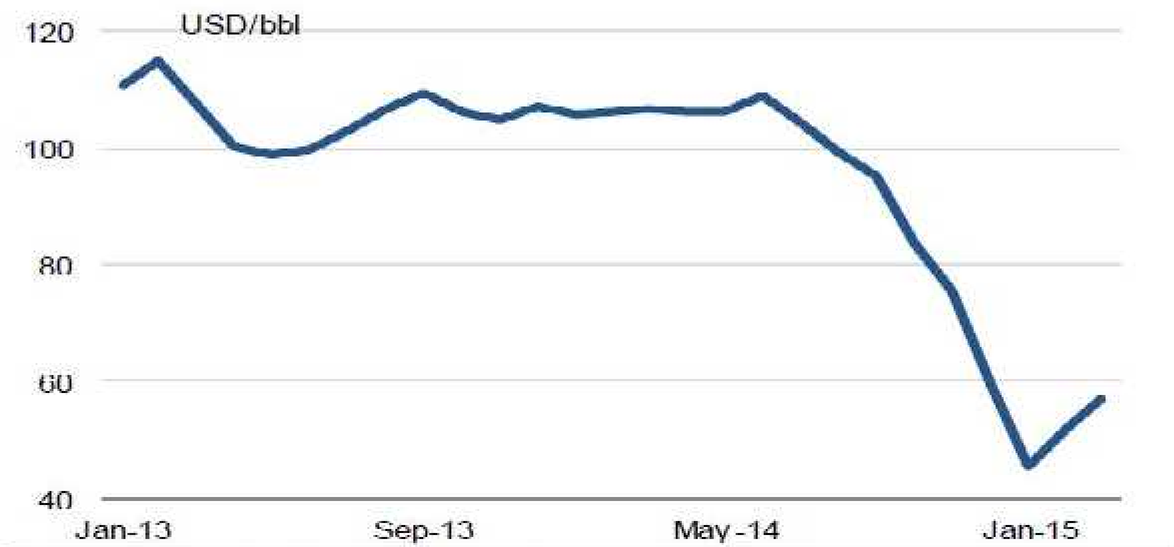
Source: Bloomberg; SG Cross Asset Research/Economics

Unfortunately, the IDR continues to face a depreciation pressure. Foreigners were the primary culprit of the Q4 financial account deterioration in Indonesia. Previous strength in bond inflows dwindled to practically zero, a worrisome development for the IDR given that the currency has been depreciating steadily since 2012 despite strong bond inflows.

Budget deficit to surprise on the downside

We do not expect the deficit to touch the 3% of GDP. The provisional fiscal deficit for 2014 printed at 2.2% of GDP, lower than our forecast of 2.5%. Given that there was a significant underperformance on the revenue front, the government was forced to curtail its expenditure – in terms of reducing the final allocation to the line ministries' budgets as well as capital expenditure. Of course, savings on the oil subsidy front from late November helped. For 2015, we expect the government to adopt a similar strategy of cutting its expenditures as economic reality hits. However, we do not expect a deep cut as that could pull down the growth rate drastically. Therefore, we increase our budget deficit expectation for 2015 to 2.6% of GDP.

Weak Indonesian Crude Price (ICP) – not an unmixed joy



Source: SKK Migas; SG Cross Asset Research/Economics

Kunal Kumar Kundu is India economist at Societe Generale based in Bangalore.