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TAXES & PUBLIC SPENDING IN INDONESIA

WHO PAYS AND WHO BENEFITS?

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List Of Acronyms, Abbreviations, And Indonesian Terms

TERM	DEFINITION
APBN	Anggaran Pendapatan dan Belanja Negara (Central Government Budget)
Bappenas	Badan Perencanaan Pembangunan Nasional (National Development Planning Agency)
BKF	Badan Kebijakan Fiskal (Fiscal Policy Agency)
BLSM	Bantuan Langsung Sementara Miskin (unconditional cash transfer program)
BPS	Badan Pusat Statistik (Central Statistics Agency)
BSM	Bantuan Siswa Miskin (Financial Assistance for Poor Students)
CEQ	Commitment to Equity
GDP	Gross Domestic Product
IDR	Indonesian Rupiah
Jamkesmas	Jaminan Kesehatan Masyarakat (Public Health Insurance)
KIP	Kartu Indonesia Pintar (Indonesia Smart Card)
MBA	Master of Business Administration
PIT	personal income tax
PKH	Program Keluarga Harapan (Family Hope Program)
Raskin	Subsidi Beras Bagi Masyarakat Berpendapatan Rendah (Rice Subsidies for Low Income People)
SD	Sekolah Dasar (Primary School)
SMA	Sekolah Menengah Atas (Senior Secondary School)
SMP	Sekolah Menengah Pertama (Junior Secondary School)
Susenas	Survey Sosial Ekonomi Nasional (National Socio-Economic Survey)
TNP2K	Tim Nasional Percepatan Penanggulangan Kemiskinan (National Team for the Acceleration of Poverty Reduction)
UDB	Unified Database
US$	United States Dollar
VAT	Value-added tax

Executive *Summary*

INEQUALITY IN INDONESIA IS RISING RAPIDLY. During the 1997-98 Asian financial crisis, poverty rose sharply, while the Gini measure of inequality fell, as the richest were the hardest hit. Since then, the Gini has increased from 30 points in 2000 to 41 points in 2014, its highest recorded level. In 2002, the richest 10 percent of Indonesians consumed as much as the poorest 42 percent combined; by 2014, they consumed as much as the poorest 54 percent. Even this is likely to be understated, as household surveys often miss the rich. Indonesia's level of inequality is now becoming high and climbing faster than most of its East Asian neighbors.

MOST INDONESIANS BELIEVE THAT URGENT ACTION IS NEEDED, OTHERWISE 205 MILLION INDONESIANS ARE AT RISK OF BEING LEFT BEHIND. Since the 1997-97 crisis, Indonesia's real GDP per capita grew at an annual average of 5.4 percent between 2000 and 2014. This has helped to create a stronger middle class than ever before; there are now 45 million people (the richest 18 percent of all Indonesians) who are economically secure and enjoy a higher quality of life. But the problem is that this segment is leaving the other 205 million, who are much less likely to enjoy benefits of growth, behind. The consequences of doing nothing to address high levels of inequality can be serious. The public shares this view; 88 percent of Indonesians who were surveyed in 2014 believed that it was urgent for the Government to address inequality.

FISCAL POLICY IS ONE OF THE KEY OPTIONS AVAILABLE TO GOVERNMENTS TO ADDRESS INEQUALITY AND IT HAS BEEN USED SUCCESSFULLY BY OTHER COUNTRIES. Fiscal policy – how and where the Government spends, and how it raises money to fund this spending – is one of the four main policy responses to addressing inequality[1]. Some countries have successfully used fiscal policy to reduce their levels of inequality; South Africa and Brazil's Gini coefficients fell by 17.5 and 14 points, respectively. In contrast, Indonesia's fiscal policy (based on 2012 data) only reduced the Gini by 3 points. With growing concern about rising inequality levels, Indonesia should look to address the problem through fiscal policy, among others.

INDONESIA COULD CHOOSE TO SPEND IN DIFFERENT WAYS, IN ORDER TO BENEFIT THOSE BEING LEFT BEHIND MORE. Education spending, which by law makes up 20 percent of the budget, is inequality-reducing, although not as much as in other countries. But Indonesia spends little on programs that are most effective in reducing inequality. Health spending, for example, benefits the poor relative to their income than it does the rich. However, the low level of spending means it has little relatively little impact on inequality. Similarly, social assistance programs are the most strongly pro-poor, but they have little impact on inequality levels due to their small size. While other countries have effectively used cash transfers to reduce inequality, Indonesia invests the least in these programs even though they are the most cost-effective inequality reducing programs.

WHILE THE GREATEST IMPACT ON INEQUALITY IS LIKELY TO COME THROUGH SPENDING CHOICES, HOW INDONESIA RAISES REVENUE CAN MATTER TOO. In Indonesia, indirect taxes such as value-added tax and tobacco excise are relatively neutral and do not have much impact on inequality. Revenue from personal income tax is low in Indonesia, making up only 10 percent of tax revenues, or around 1.9 percent of GDP. An increase in compliance and a broader tax base would increase revenues and also lower inequality. Global experience shows, however, that progressive taxation benefitting poor and vulnerable households can only help tackle inequality if it is done in a sustainable way. In other countries, personal incomes tax raises significantly more revenue and is borne to a much greater degree by the rich, helping to reduce inequality directly, as well as funding pro-poor spending.

FURTHER RESEARCH IS NEEDED TO TAKE RECENT IMPORTANT DEVELOPMENTS AND MISSING FISCAL POLICIES INTO ACCOUNT. This paper uses 2012 data but a number of new and important developments have taken place since then. Changes in fuel subsidy policies and an accompanying expansion in the scholarships program and the distribution of temporary cash assistance took place during 2013-15. As a result, further research is now needed to factor in these recent developments and also to bring in other key components of fiscal policy, such as personal income tax, that were not included in this research. To address this, the Fiscal Policy Agency of Indonesia's Ministry of Finance will collaborate with the World Bank on follow-up analytical activities.

[1] A detailed exploration of the causes and consequences of inequality in Indonesia as well as recommended policy response options can be found in the World Bank (2015a), *Indonesia's Rising Divide*.

1. RISING INEQUALITY IN INDONESIA: CAUSES AND CONSEQUENCES[2]

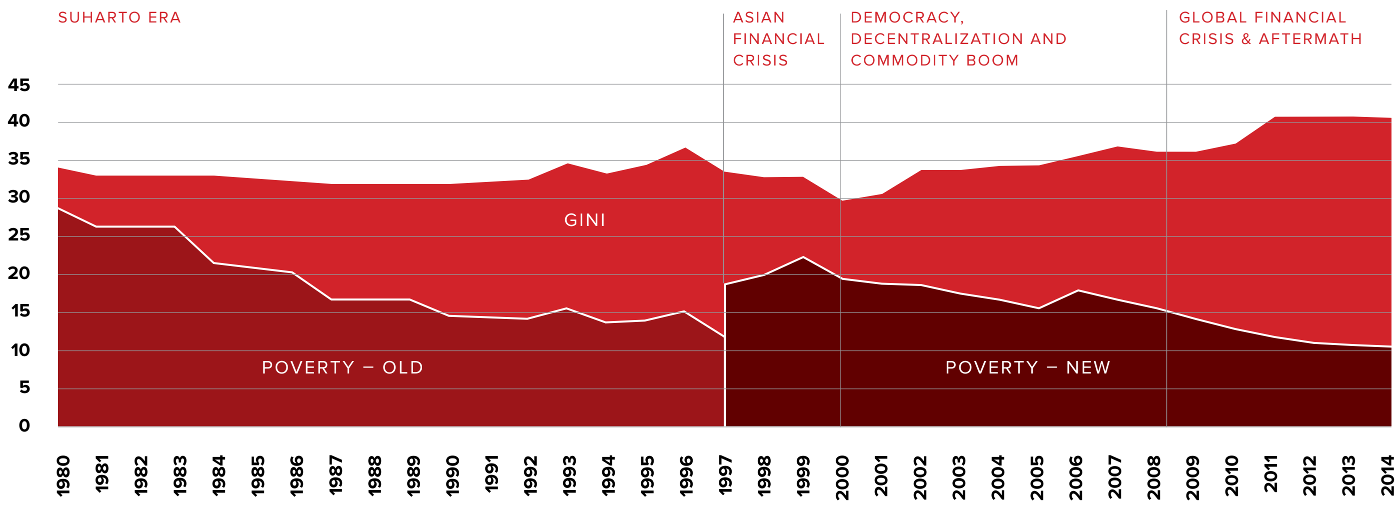
Inequality has been increasing with economic growth being primarily enjoyed by relatively few households

INEQUALITY IN INDONESIA IS RISING RAPIDLY. By most measures, inequality in Indonesia has reached historically high levels. In 2002, the richest 10 percent of Indonesians consumed as much as the poorest 42 percent combined; by 2014, they consumed as much as the poorest 54 percent. A popular measure of inequality is the Gini coefficient, where 0 represents complete equality and 100 represents complete inequality. During the 1997-98 Asian financial crisis, poverty rose sharply, while the Gini fell; everyone was affected, but the richest were the hardest hit. Since then, the Gini has increased from 30 points in 2000 to 41 points in 2014, its highest recorded level in Indonesia (Figure 1). Even this high level is likely to be underestimated, however, because household surveys tend to miss out the richest households. Once relatively moderate by international standards, Indonesia's level of inequality is now becoming high and climbing faster than most of its East Asian neighbors (Figure 2).

After a long period of stability, the Gini began rising, then fell with the Asian financial crisis, before rising sharply since the recovery.

Gini coefficient (points) and national poverty rate (percent) 1980–2014 (fig.1)

SOURCE BPS, Susenas and World Bank calculations
NOTE Nominal consumption Gini. The national poverty line was changed in 1998, and the 1996 rate calculated under both the new and old methodologies.

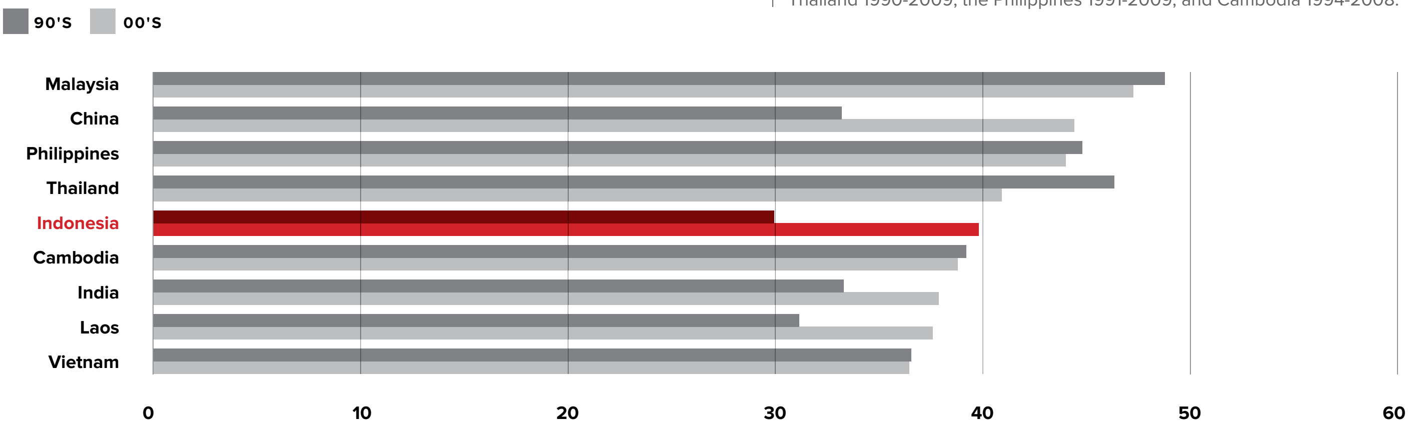


[2] This section summarizes a more detailed examination of the causes and consequences of inequality in Indonesia from World Bank (2015a), *Indonesia's Rising Divide.*

The increase in the Gini in Indonesia over the past two decades is one of the highest in the region.

Gini coefficient in East Asia 1990s & 2000s (fig.2)

SOURCE Zhuang, et al. 2014.
NOTE Consumption Ginis for all countries except Malaysia, which uses income. The periods for each country are: Indonesia 1990-2011; Malaysia 1992-2009; Lao PDR 1992-2008; China 1990-2008; Vietnam 1992-2008; Thailand 1990-2009; the Philippines 1991-2009; and Cambodia 1994-2008.



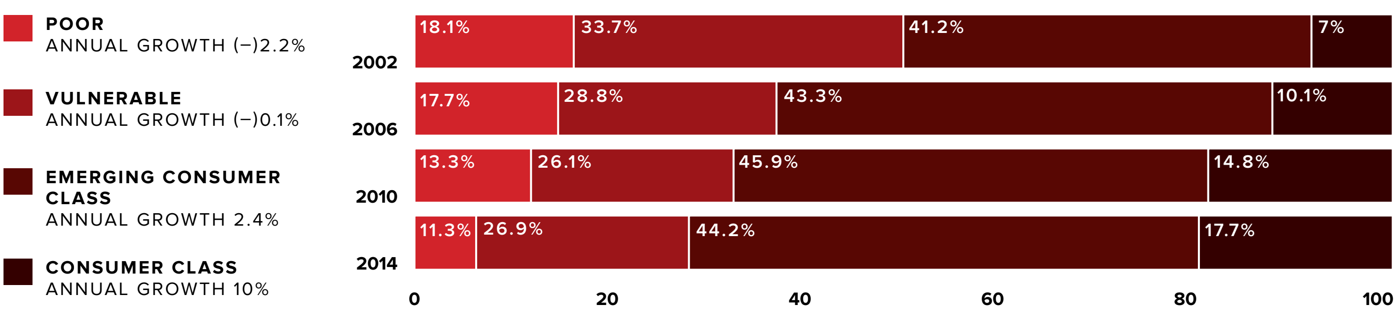
FIFTEEN YEARS OF SUSTAINED ECONOMIC GROWTH HAS REDUCED POVERTY AND CREATED A GROWING CLASS OF ECONOMICALLY SECURE HOUSEHOLDS. After recovering from the Asian financial crisis, Indonesia's real GDP per capita grew at an annual average of 5.4 percent between 2000 and 2014. This growth helped to pull many out of poverty; the poverty rate more than halved, from 24 percent during the aftermath of the crisis down to 11 percent by 2014. Economic growth has also helped to create a stronger consumer class than ever before; there are now 45 million people (the richest 18 percent of all Indonesians) who are considered economically secure and enjoying a higher quality of life. They are the fastest growing segment of the population, increasing at an average 10 percent per year since 2002 (Figure 3)[3].

HOWEVER, THE ECONOMICALLY SECURE ARE NOW LEAVING THE OTHER 205 MILLION BEHIND. The benefits of economic growth have been enjoyed largely by this growing consumer class. Between 2003 and 2010, consumption per person for the richest 10 percent of Indonesians grew at over 6 percent per year after adjusting for inflation, but grew at less than 2 percent per year for the poorest 40 percent. This contributed both to a slowdown in the pace of poverty reduction, with the number of poor people falling by only 2 percent per year since 2002, and the numbers of those vulnerable to poverty falling barely at all (Figure 3).

An economically secure "consumer" class has grown strongly at 10 percent per year since 2002, and now includes nearly one in five Indonesians, but reductions in poverty and vulnerability have been very small.

Population share by class (percent) 2002-14 (fig.3)

SOURCE Susenas and World Bank calculations. The poor are below the national poverty line of around IDR 300,000 per person per month. The vulnerable have a greater than 10 percent chance of being poor the next year and are under 1.5 times the poverty line. The consumer class is economically secure, with a less than 10 percent chance of being poor or vulnerable next year, and consume more than IDR 1 million per person per month. The emerging consumer class is safe from poverty but not vulnerability and lie between the vulnerability and economic security lines. See World Bank forthcoming (a) for more details.



[3] For this report, households in the consumer class in Indonesia are defined as those who are economically secure from poverty and vulnerability. See the note to the chart and the World Bank's forthcoming report on the middle class in Indonesia, *Indonesia's New Climbers* (forthcoming (a)), for more details.

Income inequality can be unfair when not everyone has the same initial opportunities in life

INCOME INEQUALITY IS NOT ALWAYS A BAD THING; IT CAN PROVIDE REWARDS FOR THOSE WHO WORK HARD AND TAKE RISKS. Hard work and innovation benefit society by creating new goods and services that everyone can enjoy, as well as contributing to a larger economy. This, in turn, can provide the Government with a greater ability to generate revenue and provide public services to all. If this results in a gap between those hard workers and those who work less hard, then some income inequality may be justified and even desirable. Many Indonesians share this view. When asked in a 2014 survey whether inequality is ever acceptable, 74 percent of respondents say that "inequality is sometimes acceptable" so long as wealth acquisition is fair and meritocratic (World Bank 2015b).

INEQUALITY CAN BE UNFAIR, HOWEVER, WHEN IT IS DUE TO FACTORS BEYOND THE CONTROL OF INDIVIDUALS. There are many forms of inequality. There are economic inequalities of income, wealth and consumption.[4] There are also inequalities of opportunity, when not everyone has access to the same opportunities in life. Factors beyond the control of an individual—where you are born, how educated or wealthy your parents are, and what access to public services you had when you were growing up—can have a major influence on how your life turns out. Having a healthy start in life and a quality education are fundamental prerequisites for getting a good job and earning a decent living in the future. When economic inequality arises because of this inequality of opportunity—that is, when not everyone has a fair start in life—it hurts people unfairly. There are other factors outside of an individual's control that can affect incomes, standards of living and inequality. These include government policies such as food import restrictions that increase the cost of living most for the poor, or patterns of government taxes and spending that do not collect and channel sufficient resources to help the poor and the vulnerable, or those without equal access.

High inequality can also lead to slower growth and poverty reduction, and can create conflict

HIGH LEVELS OF INEQUALITY MAY SLOW ECONOMIC GROWTH, WHILE MORE EQUAL COUNTRIES MAY GROW FASTER. High inequality may reduce economic growth for all, if poorer people are unable to properly invest in their children's development, if people fail to exit poverty and vulnerability and move into the consumer class, and if people fail to find productive jobs. Recent research indicates that a higher Gini coefficient leads to lower and less stable growth (Dabla-Norris, *et al.* 2015). Moreover, when the share of total income held by the richest 20 percent of people increases by 5 percentage points, economic growth falls by 0.4 of a percentage point. At the same time, when the share of total income held by the poorest 20 percent of people increases by 5 percentage points, economic growth increases by 1.9 percentage points. Increased income shares for the second- and third-poorest quintiles also increase economic growth.

HIGH INEQUALITY CAN ALSO HAVE NEGATIVE SOCIAL REPERCUSSIONS. When people perceive that there are large differences in income and wealth, this can create social tension and disharmony that can, in turn, create conflict. Indeed, districts with higher levels of inequality than the average in Indonesia have 1.6 times higher rates of conflict than districts with lower levels of inequality (Peirskalla and Sachs 2015). Conflict, in turn, can reduce economic growth through labor disruptions and lower investment. Furthermore, if inequality is due to rent-seeking behavior—people trying to capture existing resources without generating new wealth through productive activity—then this also has costs; individuals seek favorable treatment and protection of their positions, leading to the misallocation of resources, corruption and nepotism, all of which have high social and economic costs, including a loss of confidence in public institutions.

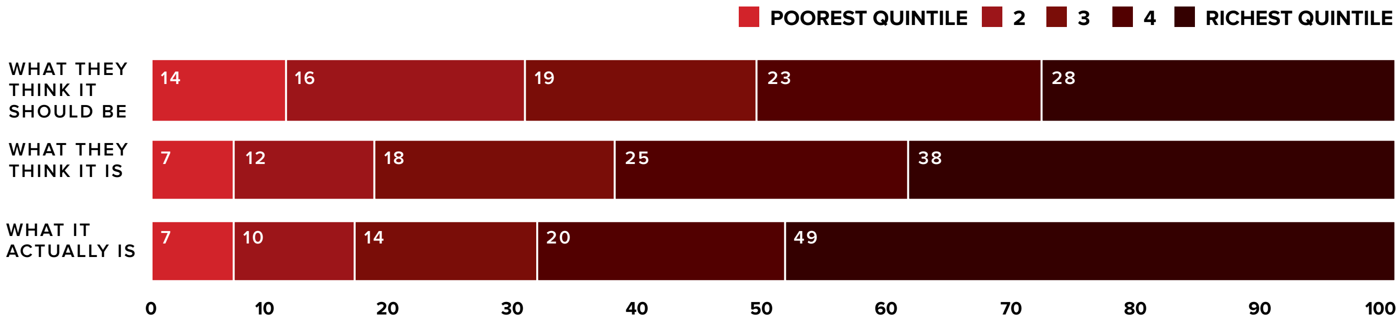
IN FACT, INDONESIANS ALREADY THINK INEQUALITY IS TOO HIGH. People surveyed estimate, on average, that the richest fifth of Indonesians account for 38 percent of all consumption (Figure 4) (World Bank 2015b). Actually, inequality is even higher than they think: national data indicate that the richest fifth really enjoy 49 percent of all household consumption4. On average, respondents indicate a preference for a more equal country, one in which the richest fifth only account for 28 percent of consumption. They may not realize, however, that this ideal would make Indonesia more equal than almost all other countries in the world.

[4] And the actual consumption Gini may even be higher, since many wealthy Indonesians are not captured in the survey data. The World Bank, Bank Indonesia and Ministry of Finance are collaborating on a project to estimate more accurately the number of middle and upper class Indonesians. The findings are published in a forthcoming World Bank report (forthcoming (b)).

Not only do surveyed Indonesians believe inequality should be lower than it is now, in reality it is even higher than they think it currently is.

Share of national consumption by each quintile: what people think it should be, what people think it is, what it really is (percent) (fig.4)

SOURCE World Bank (2015b) using LSI (2014) data.



Understanding why inequality is increasing in Indonesia through four case studies

THERE ARE FOUR MAIN CAUSES OF INEQUALITY IN INDONESIA THAT AFFECT BOTH CURRENT AND FUTURE GENERATIONS.[5] First, inequality of opportunity means that not everyone develops the skills needed to find well-paying jobs. Second, with an increasing emphasis on skill in the modern economy, the wages of these high-skilled jobs are much higher than those for low-skilled jobs. At the same time, those without the skills are becoming trapped into informal or low-productivity jobs. Third, there are inequalities in financial and physical wealth that also drive differences in income. Fourth, shocks can affect inequality at any stage of the framework by eroding a household's ability to earn an income, save, and invest in health and education.

FOUR CASE STUDIES ILLUSTRATE HOW DIFFERENT INDONESIANS ARE AFFECTED. Thirty-eight percent of Indonesians were poor or vulnerable (Figure 3) in Indonesia in 2014.[6] Putri's case is an illustrative example of the types of assets they have, the income they generate, and how shocks may affect them.[7] Similar to 44 percent of Indonesians, Fitri has escaped vulnerability but is not yet economically secure; she is a member of an emerging consumer class who could still fall back into vulnerability, but are starting to generate modest disposable income. Dewi represents the 18 percent of Indonesians who are now economically secure from poverty and vulnerability and form the new consumer class, while Siti is a member of Indonesia's upper class.[8]

THE POOR HAVE LIMITED RESOURCES, EARN LOW INCOMES FROM THEM, SAVE LITTLE FOR THE FUTURE, AND ARE THE MOST VULNERABLE TO SHOCKS. Putri (Box 1) only completed primary school. Because of her poor education, she works part-time at a *warung* (roadside food stall) and receives a low informal wage. She does own a small plot of land, which a neighbor uses to grow rice; the neighbor keeps half of the rice, while Putri's household consumes the other half. However, because Putri has four children, the rice from the land is not enough, and she needs to buy extra rice from the market, so recent rice price shocks have hurt her and her family. Over time, the land has seen small increases in value, but the lack of a formal land title means that the land value is limited and it cannot be used as collateral to borrow to start a small business. Putri has a small amount of savings that she keeps at home for hard times. As she does not earn any interest on the savings, inflation means that the value of these savings actually falls over time, and because she dips into the savings frequently over the course of the year when income is low or costs are high, the savings gradually diminish unless they are topped up. Putri also has social connections—friends and family in the local community—

[5] These four drivers are explored at length in World Bank (2015a).
[6] The poor are defined as those below the national poverty line of around IDR 300,000 per person per month. The vulnerable have a greater than 10 percent chance of being poor the next year and are under 1.5 times the poverty line. The consumer class is economically secure, with a less than 10 percent chance of being poor or vulnerable next year, and consume more than IDR 1 million per person per month. The emerging consumer class is safe from poverty but not vulnerability and lie between the vulnerability and economic security lines. See World Bank (forthcoming (a)) for more details.
[7] The following cases are illustrative examples only and not real case studies.
[8] As discussed in Footnote 7, the number of wealthier Indonesians is not well understood.

and she has relied upon these in the past to borrow money to pay her children's tuition fees. Putri has free health insurance from the Government, but does not know what it covers and there is no community health center near her anyway. If she or one of her children falls sick, she will either have to borrow from her family or sell her land to meet the health care costs.

BOX.1

Putri is poor with limited assets and low returns

Asset	Intensity of Use	Returns	Accumulation
Human Capital: SD education	Works part-time at a *warung*	Receives low informal wage	None
Physical Capital: Small area of land	Neighbor uses land to produce rice; Putri cannot use it as collateral (absence of legal title)	Neighbor keeps half the rice, Putri's household consumes the rest	Small increase in value of land, but marginal because of lack of title and development
Financial Capital: Small savings kept at home	Unused; kept to smooth consumption in the case of a shock	Negative due to inflation	None. Savings depleted and renewed throughout the year
Social Capital: Family and friend networks in local community	Used to borrow money when her children's tuition fees are due	Allows some investment in her children's education	Ongoing social activities reinforce networks

THE EMERGING CONSUMER CLASS IS ACCUMULATING MORE EDUCATION AND SOME SAVINGS. Fitri (Box 2) is a member of Indonesia's largest class—the emerging consumer class—which is above the vulnerability line but is not yet economically secure, having more than 10 percent chance of being vulnerable next year. Fitri completed junior high school and used her social connections to find a job on an assembly line at a small, locally-owned factory which, because it is a small business, does not comply with minimum wage laws. Fitri has a small amount of savings that she keeps in a basic bank account for emergencies. These savings slowly accumulate over time, as she manages to save part of her salary. Fitri does not have health insurance, because she is not poor enough to receive free health insurance from the Government, and her informal job at a small business means that she does not make contributions to the public health insurance system either.

BOX.2

Fitri is an emerging consumer with minor asset accumulation

Asset	Intensity of Use	Returns	Accumulation
Human Capital: SMP education	Works on a small-scale factory assembly line	Receives fixed salary below the minimum wage as non-unionized	None, because the factory does not offer training
Physical Capital: none	None	None	None
Financial Capital: Small savings, no pension fund	Unused; kept to smooth consumption in the case of a shock	Small interest payment from basic savings account	Salary savings
Social Capital: Family and friend networks from local community, factory worker union	Used friend network to get factory job	Factory job gives higher income than the informal alternatives	Ongoing social activities and involvement in union activities reinforces networks

THE MIDDLE CLASS HAS IMPROVING ASSETS, HIGHER INCOMES AND BETTER SAVINGS. Dewi is a member of Indonesia's middle class (Box 3). She completed high school and works as a civil servant with a good salary and benefits. She also receives ongoing training and skills certification through her work. She does not own any land or housing, but does have savings that are invested in the bank and earn interest. Over time her savings are accumulating and she is also eligible for retirement benefits. She has a network of friends and family in Jakarta, which helped her to get her job. Dewi and her husband have two children, which means that they can spend a little more on their education than if she had a larger family. Dewi has health insurance in case illness strikes, but if she were to lose her job she would need to dip into her savings.

BOX.3

Dewi is an economically secure consumer with improving assets

Asset	Intensity of Use	Returns	Accumulation
Human Capital: SMA education	Works as a civil servant	Receives good salary and benefits	Ongoing training and certification
Physical Capital: None	None	None	None
Financial Capital: Savings; retirement benefits	Invested in bank	Interest received on savings	Salary saved
Social Capital: Family and friend networks in Jakarta	Used to obtain civil servant job	Enables good formal sector wage with benefits, relative to informal sector	Ongoing social and work activities reinforces networks

RICHER INDONESIANS HAVE GOOD RESOURCES AND EARN HIGH INCOMES FROM THEM. THEY ALSO USE THIS INCOME TO SAVE, WHICH IN TURN LEADS TO HIGHER INCOME TOMORROW. Siti is a member of Indonesia's upper class (Box 4). She finished university and is about to enroll in an MBA program in the US. She receives a high salary for managing her own company, which makes a good profit. She also has investments in mutual funds and the stock market, which have seen strong returns in recent years. She reinvests the company profits back into the business to grow it, and continues to accumulate financial capital over time, which in turn earns even more income the following year. Siti is well-connected to the business and political elites, and has used these connections to secure lucrative licenses and contracts for her company. Siti and her husband have just one child, who is now attending university in Europe. A combination of savings, insurance and preventative measures means that Siti is the least affected by shocks.

BOX.4

Siti is upper class with many assets and high returns

Asset	Intensity of Use	Returns	Accumulation
Human Capital: Tertiary education	Manages her own company	Receives a high salary	Is enrolling in a US MBA
Physical Capital: Owns apartments and houses	Lives in one house and rents out the others	Enjoys high imputed rent and receives good rental income	Apartments and houses are increasing quickly in value
Financial Capital: savings; mutual funds; stocks; equity in company	Invested in financial sector and own company	Interest received on savings, high returns from funds and stocks; profits from company	Dividends and capital gains reinvested; company profits re-invested in expansion
Social Capital: well-connected to business and governing elites	Uses connections to secure lucrative licenses and contracts for her company	Company makes high profits from licenses and contracts	Extends and reinforces elite network through company contracts

RECENT CHANGES IN THE FOUR MAIN CAUSES OF INEQUALITY ALSO MEAN IT IS INCREASING. While gaps in access to health and education have closed, a quality gap remains. As a result, the gaps in health and education outcomes have not closed as much the gaps in access. Consequently, although many poorer children are staying in school longer, they are not receiving the skills they need for better jobs when they graduate. And the stakes are getting higher. With the demand for skilled labor increasing constantly, the gap between skilled and unskilled wages is also increasing, which means that inequality due to wage income is also on the rise. At the same time, not only do a small number of Indonesians hold most of the financial and physical wealth, this concentration of wealth has been increasing even further, also contributing to higher inequality. Finally, shocks are becoming more prevalent, making it increasingly hard for Indonesians outside of the top 20 percent to climb up the economic ladder. For example, people are living longer but obesity is also increasing, so non-communicable diseases such as diabetes are becoming an increasingly common problem.

Given the high level of inequality in Indonesia and public concern, the consequences of doing nothing could be serious; urgent action is needed

GIVEN THIS PERCEPTION, MOST INDONESIANS FEEL THAT URGENT ACTION IS NEEDED, WHICH IS WHY INEQUALITY HAS BECOME A MAJOR PUBLIC ISSUE. Inequality was a key issue in the run-up to the Indonesian presidential election in 2014, with major national and international media outlets reporting on rising inequality and both presidential candidates making public statements about strategies to reduce inequality. They have the support of the public; 47 percent of those surveyed say it is "very urgent" for the Government to address inequality, and another 41 percent believe it is "quite urgent" (World Bank 2015b).

FOUR HIGH PRIORITY ACTIONS FOR REDUCING INEQUALITY HAVE BEEN IDENTIFIED (WORLD BANK 2015A). These are: improving local service delivery to provide health and education opportunities for all; creating better jobs and skills training opportunities for the workforce; ensuring better protection from shocks; and getting fiscal policy right. Thinking about fiscal policy means thinking about how and where the Government spends its money, and how it raises money to fund this spending. This last action is the focus of this paper.

2. ADDRESSING INEQUALITY: THE ROLE OF FISCAL POLICY

Fiscal policy: the choices government makes about how it raises money and how it spends it

FISCAL POLICY IS THE COMBINATION OF A GOVERNMENT'S PATTERNS OF RAISING MONEY AND SPENDING IT. Economists believe that the choices a government makes about how it raises money and how it spends that money can influence economic outcomes, such as economic growth, household and firm consumption, savings and investment, and the distribution of income. The combination of how a government collects revenue and spends that revenue is called 'fiscal policy'.

FISCAL POLICY INCLUDES HOW A GOVERNMENT RAISES REVENUE. There are two main instruments to fiscal policy. First, a government usually uses taxes to raise most of its revenues. How much tax to raise and from what types of tax to use are the first fiscal policy choices a government makes. For example, what personal income tax rates does it set, and at what levels? What corporate tax rates? How much money does it raise from property taxes or sales and value-added taxes? And how much revenue comes from tobacco and alcohol excise tax?

FISCAL POLICY ALSO INCLUDES HOW A GOVERNMENT SPENDS MONEY. Second, a government can choose to spend in different ways. Some money must go towards paying the salaries of civil servants; how many civil servants does it want? How much should be spent on law and order, and defence. How much on health, education and social protection? And how much should be invested in the country's capital stocks—bridges, railroads, highways, power plants, and water and sanitation?

FISCAL POLICY AFFECTS ECONOMIC OUTCOMES, INCLUDING GROWTH, JOBS AND INEQUALITY. These two elements of fiscal policy can influence growth and jobs. Investments in infrastructure, for example, can improve the productivity of today's workers, while investments in health and education can improve the productivity of tomorrow's workers. Taxes and tax credits provide incentives and disincentives to work, save and invest in different ways, which can in turn affect economic growth. And who pays which taxes and who receives which spending affects the final distribution of income.

Fiscal policy can help address inequality in both the short term and the long term

FISCAL POLICY CAN HELP REDUCE INEQUALITY IN THE LONG TERM. How can fiscal policy help to address inequality? It can help in two ways. First, a government can choose to spend money on policies and investments that can address inequality in the long term. We have seen that a key driver of inequality in Indonesia is unequal opportunity. More spending on health and better spending on education could help poorer and children in remote regions to receive a better start in life and develop the skills needed in the modern workplace. At the same time, greater investments in infrastructure would make firms and workers more productive, connect firms to their markets, and reduce costs. This could lead to more skilled jobs being created, which would pay better incomes to those new skilled workers who are coming out of the improved health and education systems.

FISCAL POLICY CAN ALSO HELP TO REDUCE INEQUALITY IN THE SHORT TERM. Unlike many policies for reducing inequality, fiscal policy can also have significant short-term effects. For example, greater investments in health and education for today's children are a vital part of reducing inequality. But these policies will take years to have an impact. Fiscal policy can address inequality now in two ways. First, it can raise revenues using taxes that are paid more by richer households. For example, in many countries, the rich pay more in personal income taxes. Second, it can spend in ways that benefit the poor and vulnerable the most. For example, spending on targeted social assistance for the poor and vulnerable can help invest in their children's health and education, reducing inequality tomorrow, while also providing them income support, reducing inequality today.

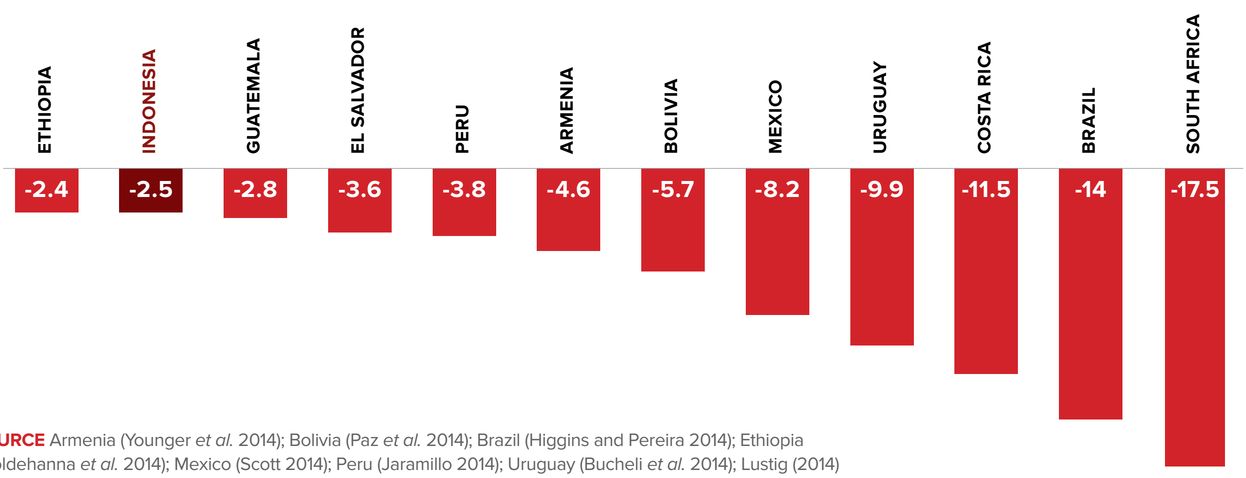
Fiscal policy has been used in other countries to significantly reduce inequality, but currently in Indonesia it does not significantly change inequality

THERE ARE TWO TIMES AT WHICH WE CAN ESTIMATE HOUSEHOLD INCOMES: BEFORE THE IMPACT OF ANY FISCAL POLICY AND AFTER THE IMPACT OF ALL FISCAL POLICY. Consider two different stages of income. The first is market income. This is the income a household receives from all wages and salaries, all rents, interest and dividends, and all other private transfers, but before they pay any taxes and pension contributions, and before they receive any public benefits, whether directly (such as cash transfers or tax credits), indirectly (such as by purchasing subsidized rice or gasoline), or in-kind (such as subsidized education and health). The second stage of income is final income, which is a household's market income, plus all direct, indirect and in-kind benefits received from a government, less all taxes it has paid.

A NUMBER OF COUNTRIES HAVE INTENTIONALLY USED FISCAL POLICY TO REDUCE INEQUALITY. However, in Indonesia, fiscal policy currently has little impact on inequality. In a number of countries, often in Latin America where inequality is the highest of any region, the choice of taxes and spending has been made with a view to reducing inequality. We can see how inequality in a country changes when we compare the distribution of market incomes (unaffected by fiscal policy) and final incomes (fully affected by fiscal policy). In Brazil, for example, the Gini coefficient for market income is 14 points higher than it is for final income, indicating a very large reduction in inequality due to fiscal policy (FIGURE 5). In South Africa it is even higher (17.5 points). Reductions of 6 points or more are also seen in Costa Rica, Uruguay, Mexico and Bolivia. However, in Indonesia, the Gini coefficient is reduced by only 2.5 points, the second-lowest in the 12-country study set after Ethiopia. The rest of this paper explores why this should be so. Who does benefit from spending in Indonesia? Who is paying which taxes, and how much?

The impact of fiscal policy on inequality is very different across the countries studied. For example, the Gini falls by less than 3 points in Indonesia, but by 14 points in Brazil and 17.5 in South Africa.

Reduction in Gini coefficient from market income to final income. (fig.5)



SOURCE Armenia (Younger *et al.* 2014); Bolivia (Paz *et al.* 2014); Brazil (Higgins and Pereira 2014); Ethiopia (Woldehanna *et al.* 2014); Mexico (Scott 2014); Peru (Jaramillo 2014); Uruguay (Bucheli *et al.* 2014); Lustig (2014) based on Costa Rica (Sauma *et al.* 2014), El Salvador (Beneke de Sanfeliu *et al.* 2014), and Guatemala (Cabrera *et al.* 2014); South Africa (Inchauste *et al.* 2014); and own estimates for Indonesia based on Susenas 2012.

3. WHAT THE GOVERNMENT CHOOSES TO SPEND ON CAN AFFECT INEQUALITY

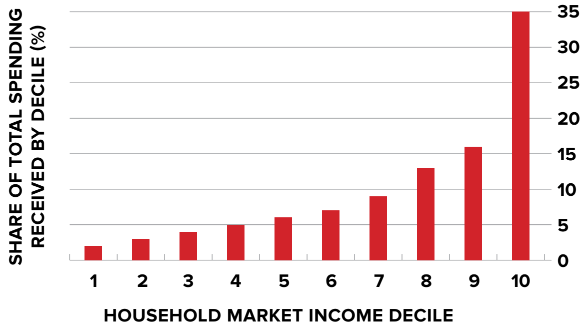
A government can choose to spend in different ways, which benefit different people. The same benefit can also mean different things to people on different incomes

THERE ARE MANY PROGRAMS AND POLICIES THAT GOVERNMENTS CAN SPEND MONEY ON. Governments have a number of spending choices covering a wide range of activities, including defence and the military; governance and administration; building infrastructure such as roads, bridges and power plants; social spending such as health, education and social protection; and subsidies for energy, food and inputs such as fertilizer.

EACH OF THESE CAN BENEFIT DIFFERENT GROUPS OF PEOPLE IN DIFFERENT WAYS. In particular, we are interested in how much of the total benefits go to richer and poorer households, and how much these benefits actually mean to these households. Figure 6 and Figure 7 are examples of how we present these two ideas in this paper in the Indonesian case. In both figures, we group households into 10 equally sized groups of 10 percent of the population, called deciles. Decile 1 is the poorest 10 percent, decile 2 the second-poorest, all the way up to decile 10, which is the richest 10 percent. Figure 6 looks at how much of total spending goes to each decile. These are example numbers only, and could represent any type of spending. In this example, the richest decile clearly gets far more—35 percent of total spending—than any of the other deciles, and the poorest 7 deciles all get less than 10 percent of spending each. If the spending were perfectly equal, all deciles would get 10 percent; if the spending was pro-poor, the poorest deciles would get more than 10 percent each. Figure 7 shows exactly the same spending, but this time, instead of showing what share of the total each decile receives, it shows the average benefit received by households in that decile, measured as a share of their average market income. That is, in this example, although poorer households do not receive as much as richer households in dollar terms, because their incomes are so much lower it feels as though it is more to them: it represents a larger increase in their market incomes than it does for the richer households.

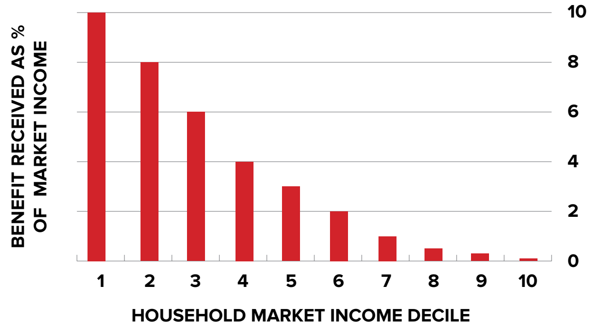
In some cases, more of the total amount of spending might go to richer households...

Absolute benefit of spending (fig.6)



...but the smaller amount received by poorer households might still represent a greater share of their market incomes.

Relative benefit of spending (fig.7)



HOW DO WE WORK THIS OUT? We combine government revenue and spending data to know how much revenue was raised from which sources and how much was spent in different areas, with household survey data, to know who paid which taxes and how much, and who benefitted from which spending and by how much. Box 5 provides a summary of how we do this.

BOX.5

Overview of methodology and data[9]

We begin with *market income*, which as explained, is all household income from non-government sources, including income from working (wages and salaries), income from savings and investments (rents, interest, dividends), transfers from other households or individuals (such as remittances).

From the market income, some households will pay personal income taxes or contributions to public pension plans, which reduces *market income* down to net market income. Some households can receive cash transfers (such as from social assistance programs like *Program Keluarga Harapan*, or PKH, Indonesia's conditional cash transfer), which will lead to a higher *disposable income*, available for consumption[10]. When households consume, they can buy goods that are subsidized by the Government, such as fuel or food. This has the effect of increasing their effective income, as they are not paying the full price and are indirectly receiving government spending. At the same time, they may be paying taxes on their consumption, through sales taxes, value-added taxes (VAT), or excise taxes such as on tobacco and alcohol. In this case the final price they pay is higher than the market price, and they are indirectly providing revenues to the Government. The *post-fiscal income* is a household's disposable income, adjusted for how much the household is indirectly receiving from and paying to the Government through its consumption. Finally, households can consume subsidized public services, such as health and education, which represent a transfer to the household in-kind (in a non-cash fashion). However, households may also pay some fees as part of receiving these services, which reduces the benefit to them. The *final income* takes into account both the cost of the in-kind services received and any payments the household makes.

To work out who is paying which taxes and who is receiving which benefits, we use the National Socio-economic Survey (*Survei Sosial Ekonomi Nasional*, or Susenas). This household survey includes which households receive cash or near-cash transfers (PKH, BSM, Raskin), how much households spend on subsidized energy (fuel and electricity), and how many children they have in school at which level, as well as the number of in-patient and out-

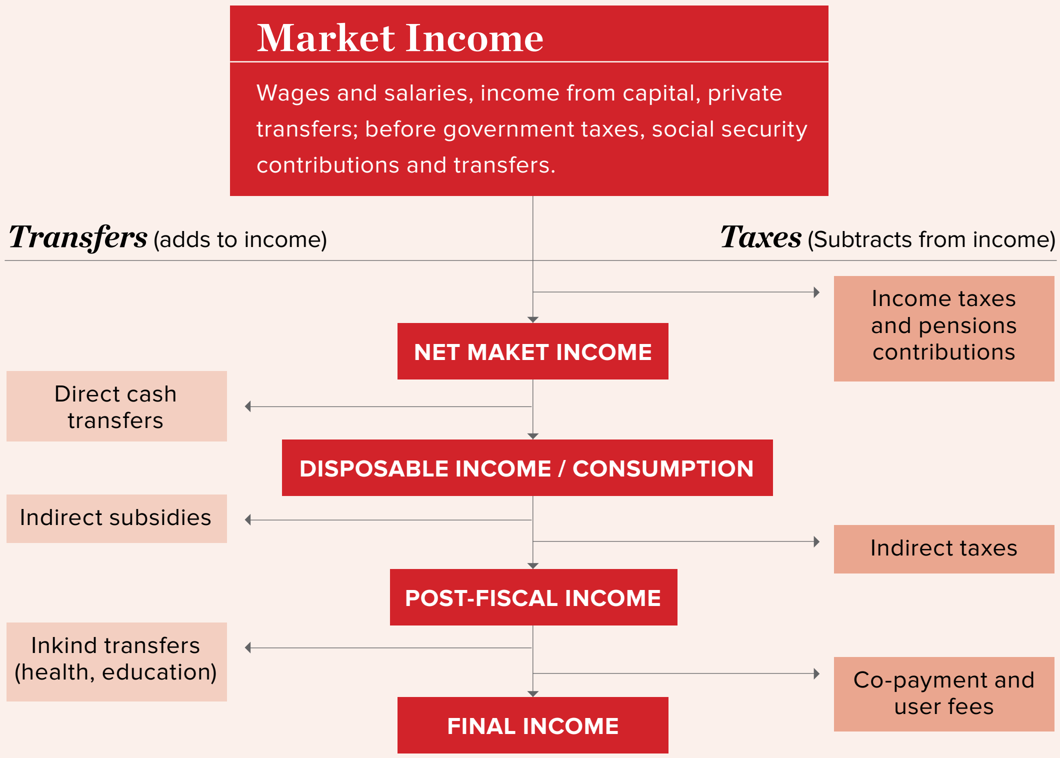
[9] This policy paper summarizes Jellema, et al.(2015). This paper is part of the project "The Distributional Impact of Fiscal Policy," a collaboration of the World Bank and the Department of Economics at Tulane University to implement its diagnostic tool, the Commitment to Equity (CEQ) assessment to six middle income and developing countries. Led by Nora Lustig since 2008, the CEQ project is an initiative of the Center for Inter-American Policy and Research (CIPR) and the Department of Economics at Tulane University, the Center for Global Development and the Inter-American Dialogue. For more details visit www.commitmentoequity.org.

[10] Only consumption is observed in the Indonesian data, which is taken to be the same as disposable income. In reality, some households, particularly richer ones, will save a part of their income.

BOX.5 (CONT.)

patient health visits they have made. The survey also tells us how much each household spent on what items, which allows us to calculate VAT and tobacco excise.

We also have tax and spending from Indonesia's national accounts and administrative fiscal data. We combine these with the Susenas data to determine how much of each spending a household benefits from. For example, if the Government spends on average US$1,000 per primary school child, and US$3,500 per junior secondary child, then a household with two primary children and one junior secondary child receives in-kind education spending benefits equal to US$5,500. If each liter of fuel is subsidized by US$0.50, then a household that consumes 100 liters per month receives a US$50 subsidy benefit per month, or US$600 per year.



SOURCE Lustig and Higgins (2013).

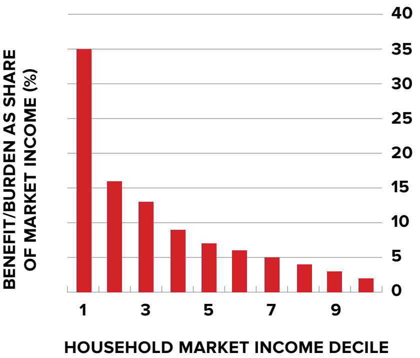
When the benefit to the poor is greater than it is to the rich, as a proportion of their market income, inequality falls

IT IS THE BENEFIT OR BURDEN AS A PERCENTAGE OF MARKET INCOME THAT MATTERS MOST FOR INEQUALITY, NOT THE ABSOLUTE AMOUNT. Most measures of inequality rise or fall based on changes in relative incomes. That is, if a poor household and a rich household both see their incomes increase by 10 percent, inequality stays equal, even though the absolute increase of the poorer income is smaller than that of the richer income. For example, if a poor household earns US$100 a month and rich household US$500 a month, then an increase of 10 percent means an extra US$10 for the poor households but US$50 for the rich household. Nonetheless, inequality stays the same, because the ratio between the two incomes remains the same. By the same token, when a tax is paid, it is the tax relative to market income that affects inequality. If the poor household pays US$1 in consumption tax and the rich household pays US$1 in consumption tax, inequality goes up, because the poor household can afford to pay it less (US$1 is 1 percent of their market income but only 0.2 percent of the rich household's income). Similarly, if the poor household pays US$20 a month in income tax and the rich household pays US$100 a month, inequality stays the same, because both amounts are the same as a percentage of each household's market income.

SO WHEN WE LOOK AT HOW SPENDING AND TAXES AFFECT INEQUALITY IN INDONESIA, WE ARE INTERESTED MOST IN THE DISTRIBUTION OF THE BENEFIT OR BURDEN RELATIVE TO THE MARKET INCOME. There are three types of relative incidence graphs; ones that slope downwards, ones that slope upwards, and ones that are flat. Downward sloping relative graphs (Figure 8) mean that inequality is reduced in the case of spending (the poor receive more as a percentage of their market income than the rich) and increased in the case of a tax (the poor pay more as a percentage of their market income than the rich). Conversely, an upward sloping relative graph (Figure 10) means increasing inequality for spending or decreasing inequality for taxes. A flat curve means inequality is unchanged (Figure 9).

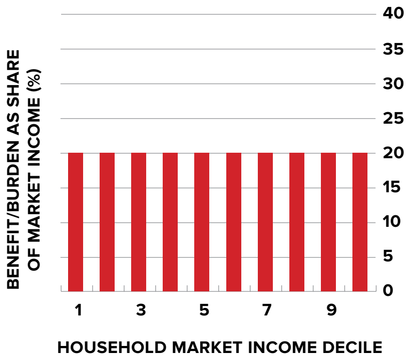
A downwards sloping relative incidence curve means inequality is reduced in the case of spending or increased in the case of a tax.

Relative benefit of spending as a percentage of market income (fig.8)



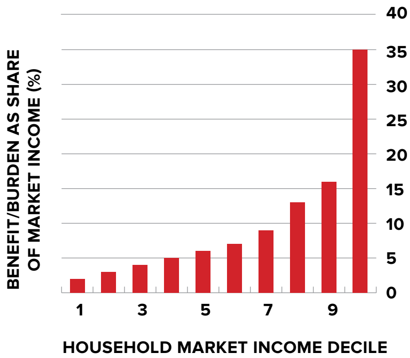
A flat relative incidence curve means inequality is unchanged for both spending and taxes.

Relative benefit of spending as a percentage of market income (fig.9)



An upwards sloping relative incidence curve means inequality is increased in the case of spending or decreased in the case of a tax.

Relative benefit of spending as a percentage of market income (fig.10)



Where does Indonesia's public spending go, and how does it affect inequality?

IN 2012, THE LARGEST SPENDING ITEM WAS ENERGY SUBSIDIES, FOLLOWED BY EDUCATION. Thirty percent of Indonesia's 2012 public spending was on social spending (Table 1), of which the majority was for education, which by law must make up 20 percent of the budget. The greatest spending was on subsidies (25 percent), most of which was on fuel subsidies (although sweeping reforms by the new administration in 2015 mean that this is now much lower). Only 5 percent was spent on health, and less than 3 percent was spent on social assistance through cash transfers targeting poor and vulnerable households.

THIS PAPER LOOKS AT 57 PERCENT OF TOTAL PUBLIC SPENDING, COVERING SOCIAL SPENDING, ENERGY SUBSIDIES AND CONTRIBUTORY PENSIONS. Of Table 1, 57 percent of total spending is included in this study. The two largest components studied are energy subsidies and education, which together make up 73 percent of total public spending on social, subsidies and pensions (Figure 11). For methodological reasons, we exclude spending on housing and urban, and other subsidies (mostly fertilizer and seeds), but these are relatively small.

We look at social spending, contributory pensions and energy subsidies, which make up 57.3 percent of total primary spending.

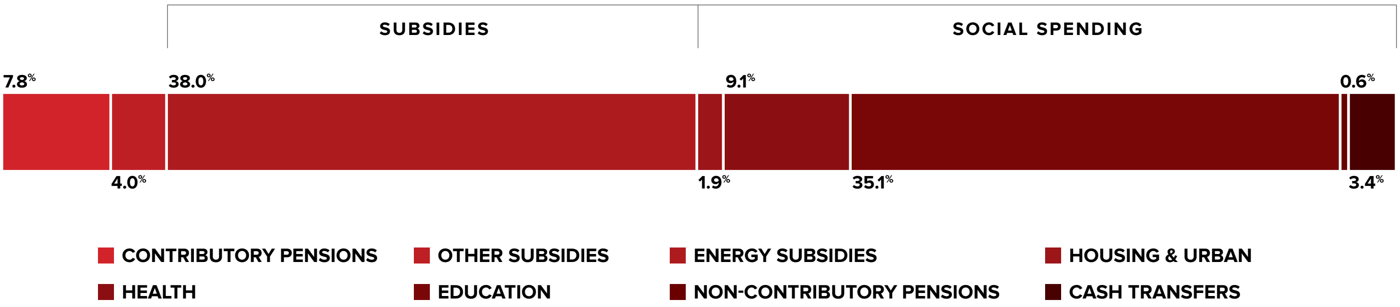
Indonesian primary spending 2012 (tab.1)

APBN 2012 (Realized)	IDR trillion	% GDP	% Primary spending
1. Social spending	400	4.9	29.9
2. Contributory pensions	63	0.8	4.7
3. Non-social spending	867	10.6	65.4
a. Energy subsidies	304	3.7	22.7
b. Other subsidies	32	0.4	2.4
c. Other	540	6.6	40.3
Primary spending	**1,339**	**16.2**	**100**

SOURCE Ministry of Finance

Of this, a combined 73 percent goes to energy (38 percent) and education (35 percent).

2012 APBN (Realized) social, pension and subsidy spending by type (fig.11)



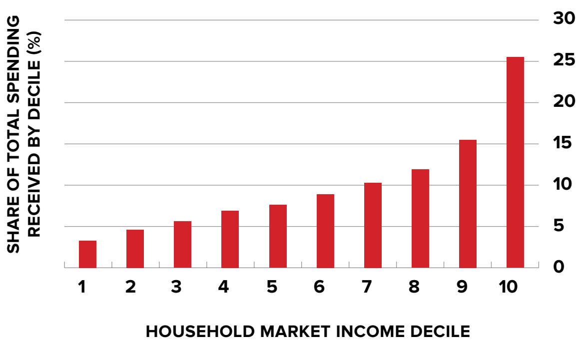
The most spending goes on energy subsidies, which do little to reduce inequality, although they still have significant value for the poor and vulnerable

EIGHT TIMES MORE ENERGY SUBSIDIES—THE LARGEST SPENDING ITEM—GO TO THE RICHEST DECILE THAN TO THE POOREST DECILE. Energy subsidies, which make up 25 percent of all spending and 38 percent of spending looked at in this paper, are enjoyed significantly more by richer households, which are more likely to have cars and motorcycles, than by poorer households. Over half of the subsidies go to the top three deciles, with one-quarter alone to the richest 10 percent (Figure 12). The poor and vulnerable—the poorest 40 percent of Indonesians—receive only 20 percent of all energy subsidy benefits.

NONETHELESS, THE SUBSIDIES MEAN SLIGHTLY MORE TO THE POOR AND VULNERABLE AS A SHARE OF THEIR INCOME. When we consider the benefits received as a proportion of their market income, the distribution is much flatter, with subsidies received meaning slightly more to the poorest four deciles than the richer ones (Figure 13). As a consequence, subsidies have relatively little impact on inequality one way or another. Given the large amount spent on them, they represent poor value for money if they are intended to benefit the poor and vulnerable the most. Still, representing around 9-10 percent of market income for most Indonesians, their removal will be felt.

Most subsidy spending goes to richer households...

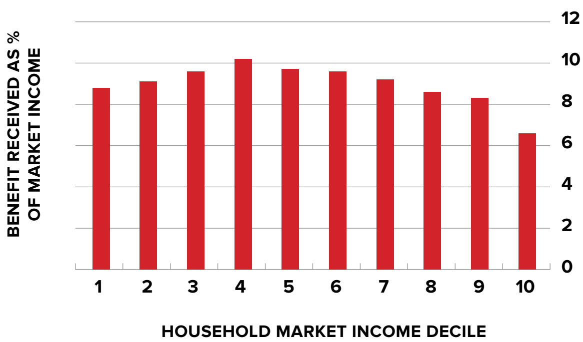
Absolute benefit of energy subsidy spending (fig.12)



SOURCE Susenas 2012, APBN 2012 (Realized), World Bank calculations.

...but it means slightly more as a share of their income to the poor and vulnerable.

Relative benefit of energy subsidy spending (fig.13)



SOURCE Susenas 2012, APBN 2012 (Realized), World Bank calculations.

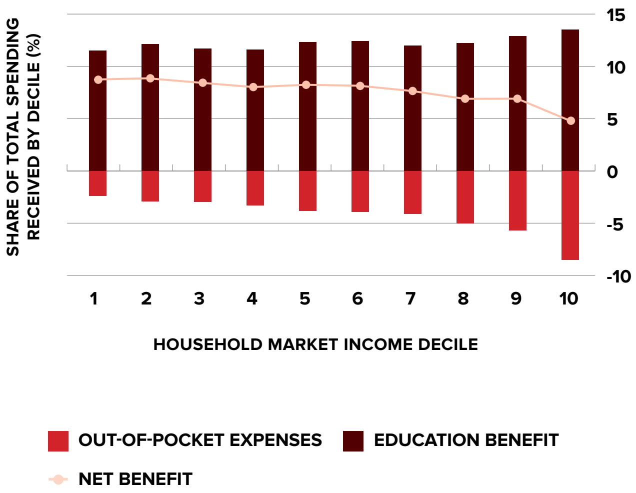
Education benefits are significantly more for poorer households as a share of income, and are significantly inequality-reducing, although not as much as in other countries

RICHER HOUSEHOLDS RECEIVE SIMILAR LEVELS OF EDUCATION SPENDING AS POORER HOUSEHOLDS, BUT BECAUSE OF OUT-OF-POCKET EXPENSES, THEY PAY MORE INTO THE SYSTEM. When considered in absolute terms, richer households benefit slightly more from education spending than poorer households (Figure 14). Despite having fewer children who are more likely to be enrolled in private schools[11], their children are also more likely to be enrolled at the more expensive secondary and tertiary levels. However, when we include out-of-pocket expenses such as school fees, the net benefit of education spending is slightly higher for poorer households (Figure 14).

HOWEVER, BECAUSE OF THEIR MUCH LOWER INCOMES, THE BENEFITS ARE WORTH FAR MORE TO POORER HOUSEHOLDS, MAKING EDUCATION SPENDING INEQUALITY-REDUCING IN INDONESIA. When we consider the education benefits as a share of market income, it is nearly 20 percent for the poorest decile compared with only 2 percent for the richest decile (Figure 15). A similar pattern holds after accounting for out-of-pocket costs. As a consequence, education spending is inequality-reducing in Indonesia.

Most households receive similar education benefits, but because richer households pay more out-of-pocket, poorer households receive a much greater net benefit than richer households...

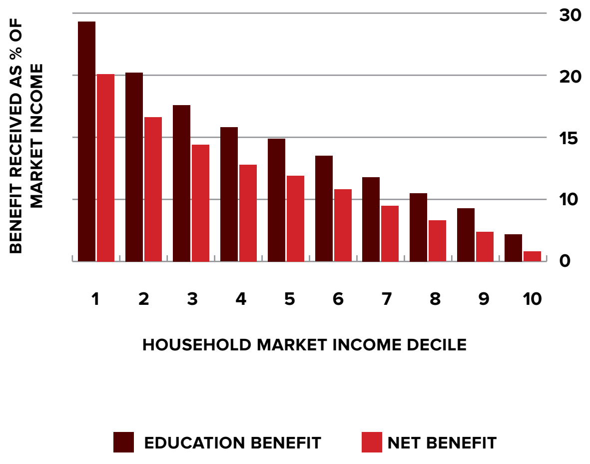
Absolute benefit of education spending and burden of out-of-pocket expenses (fig.14)



SOURCE Susenas 2012, APBN 2012 (Realized), World Bank calculations.

...but relative to household income, education spending benefits poorer households much more than richer ones.

Relative benefit of education spending and burden of out-of-pocket expenses (fig.15)



SOURCE Susenas 2012, APBN 2012 (Realized), World Bank calculations.

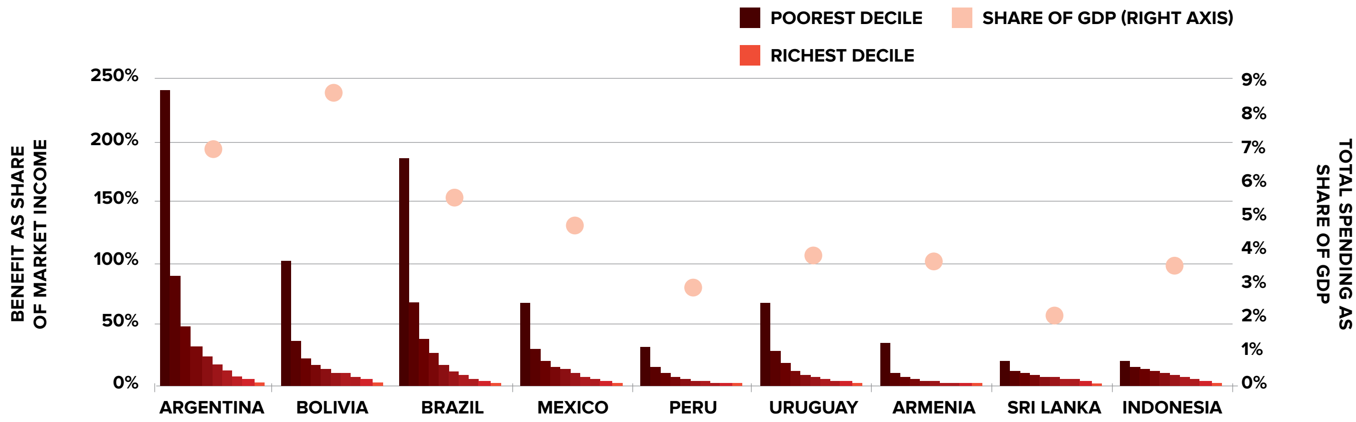
NONETHELESS, EDUCATION SPENDING BENEFITS POORER HOUSEHOLDS AND REDUCES INEQUALITY BY MUCH LESS IN INDONESIA THAN IN OTHER COUNTRIES. When we compare who benefits from education spending in Indonesia with other countries studied, poorer households, especially those in the poorest decile, benefit much more as a percentage of their market income in other countries. This likely reflects a greater focus on primary education spending in these countries.

[11] Although private schools also receive some public subsidies, which are captured in this analysis.

Education spending reduces inequality considerably more in other countries.

Relative benefit of education spending (fig.16)

SOURCE For Latin America see: Lustig and Pessino 2014; Paz, *et al.* 2014; Higgins and Pereira 2014; Scott 2014; Jaramillo 2014; Bucheli, *et al.* 2014; Lustig, *et al.* 2014. For Armenia and Sri Lanka, results are preliminary by Younger, *et al.* (2014) and Arunatilake, *et al.* (2014).



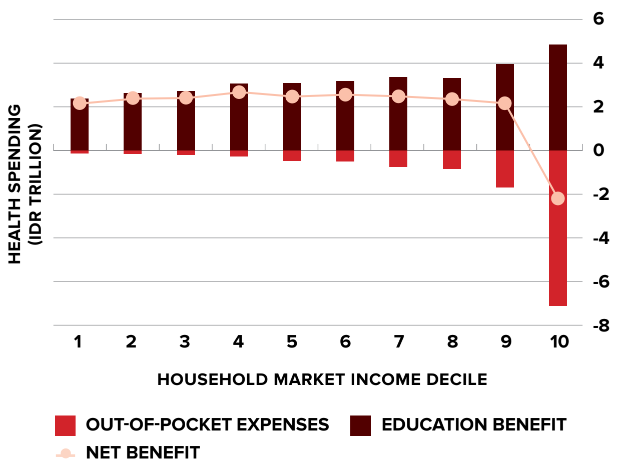
More health spending goes to richer households, but it means more to the poor. However, other countries spend more overall and direct it more effectively to the poor

MOST INDONESIANS RECEIVE THE SAME NET HEALTH BENEFITS IN SPENDING TERMS, BUT THE RICHEST HOUSEHOLDS PAY MORE INTO THE SYSTEM THAN THEY RECEIVE. The share of total health spending increases from poorer to richer households (Figure 17). However, out-of-pocket expenses also increase with income, meaning that the net benefit is relatively similar for all but the richest decile. The richest 10 percent of Indonesian households, however, pay more in expenses than they receive in benefits, so they are net payers into the public health system.

THE RELATIVE HEALTH BENEFIT IS INEQUALITY-REDUCING, BUT THE LOW SPENDING LEVELS MEAN THAT IT HAS RELATIVELY LITTLE IMPACT. The net health benefits relative to market income mean around four times more to the poorest decile than to the richest decile, which actually pays a small amount into the system after out-of-pocket expenses are considered (Figure 18). However, even for the poorest decile, the value of the net health benefit is less than 4 percent of their market income. As a consequence, while health spending is inequality-reducing, the low spending levels mean that it makes little real difference.

Most Indonesians receive the same net health benefits, but the richest households pay more into the system than they receive.

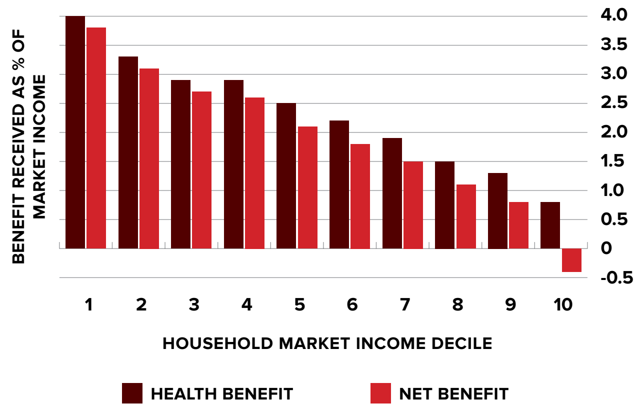
Absolute benefit of health spending and burden of out-of-pocket expenses (fig.17)



SOURCE Susenas 2012, APBN 2012 (Realized), World Bank calculations.

Health benefits mean most to the poor, but even for those with the lowest income, they are worth less than 4 percent of their income, so matter little.

Relative benefit of health spending and burden of out-of-pocket expenses (fig.18)



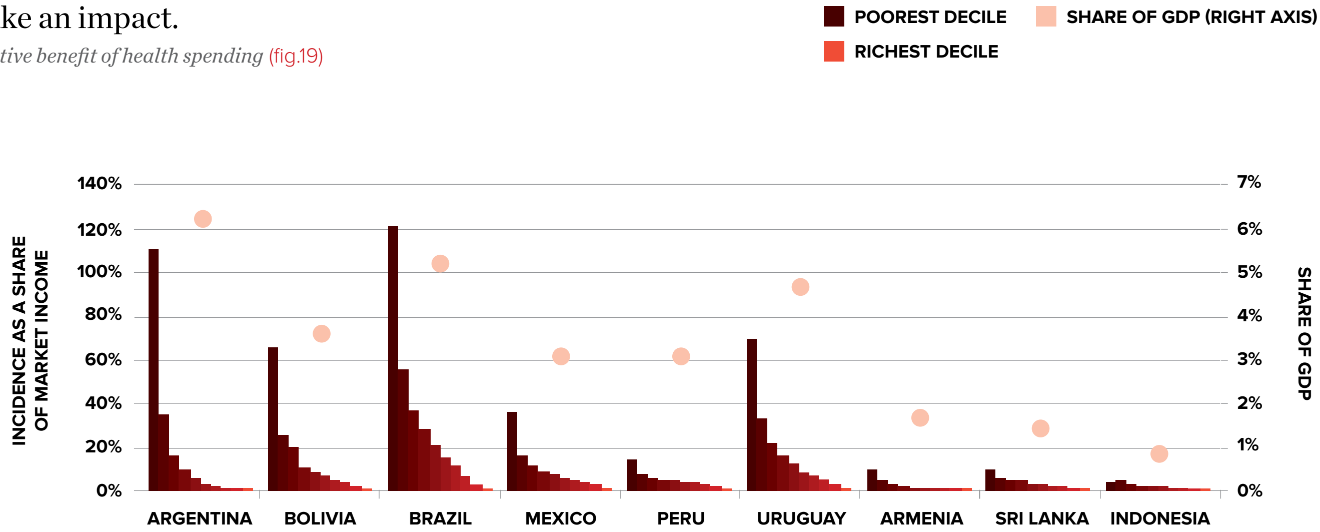
SOURCE Susenas 2012, APBN 2012 (Realized), World Bank calculations.

HEALTH SPENDING REDUCES INEQUALITY MORE IN OTHER COUNTRIES, BECAUSE IT IS MORE PRO-POOR AND BECAUSE HIGHER OVERALL SPENDING LEVELS MEAN THAT IT IS BIG ENOUGH TO HAVE AN IMPACT. Indonesia not only spends the least on health of the countries studied[12], but health spending also benefits the poor more in other countries (Figure 19). As a consequence, health spending is more inequality-reducing in most of these other countries than it is in Indonesia. Moreover, greater spending on health in general would benefit Indonesia as a whole, with the persistently high stunting rate and growing incidence of non-communicable diseases, as well as the poor and vulnerable, who are more likely to use public health services than the middle class, who tend to use private health services (World Bank 2015c).

Health spending reduces inequality considerably more in other countries, because it is more pro-poor and because higher overall spending levels mean it is big enough to make an impact.

Relative benefit of health spending (fig.19)

SOURCE For Latin America see: Lustig and Pessino 2014; Paz, *et al.* 2014; Higgins and Pereira 2014; Scott 2014; Jaramillo 2014; Bucheli, *et al.* 2014; Lustig, *et al.* 2014. For Armenia and Sri Lanka, results are preliminary by Younger, *et al.* (2014) and Arunatilake, *et al.* (2014).



Social assistance is strongly pro-poor, but has little impact on equality because too little is spent in general, and on the most effective programs in particular

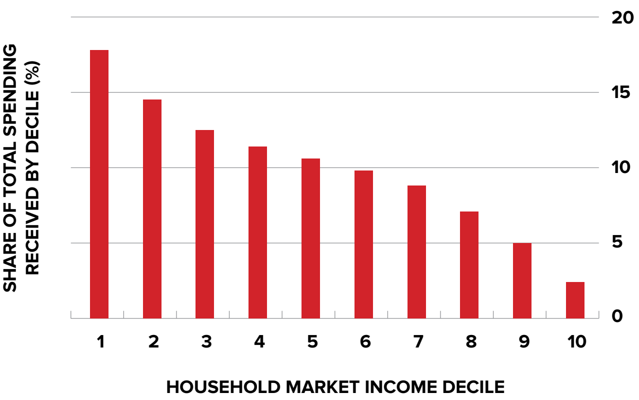
SOCIAL ASSISTANCE SPENDING IN INDONESIA IS EASILY THE MOST PRO-POOR SPENDING OF ALL, WITH NEARLY 60 PERCENT GOING TO THE POOR AND VULNERABLE AND LITTLE TO THE RICH. Indonesia has a number of social assistance programs targeting the poor and vulnerable, including Jamkesmas (health insurance for the poor, now part of the national health insurance scheme *Jaminan Kesehatan Nasional*, or JKN), Raskin (subsidized rice for the poor)[13], BSM (*Bantuan Siswa Miskin*, financial assistance for poor students, now Kartu Indonesia Pintar) and PKH (*Program Keluarga Harapan*, a conditional cash transfer). Much of this spending does go to the poor, with the poorest four deciles receiving 56 percent of all benefits, the middle three deciles 30 percent, and the richest three deciles only 14 percent (Figure 20).[14]

THESE CASH TRANSFERS MEAN EVEN MORE TO POORER HOUSEHOLDS RELATIVE TO THEIR INCOMES, BUT THE AVERAGE BENEFIT LEVEL IS LOW AND THE MOST PRO-POOR PROGRAM, PKH, IS THE SMALLEST. When considered relative to household incomes, the targeted cash transfer programs are even more pro-poor and therefore inequality-reducing (Figure 21). However, they have little impact on inequality because the total spending is the lowest of all the spending analyzed here—when combined the transfers average only 4 percent of the poorest decile's income—and because the most pro-poor program, PKH (see Figure 25 and later discussion), has the smallest budget (IDR 2 trillion compared with IDR 11.5 trillion for Raskin and BSM).

[13] Heavily subsidized, Raskin is considered a near-cash transfer, as households pay relatively little for staple.
[14] This excludes Jamkesmas, which does not provide a cash transfer (or near-cash in the case of Raskin).

The poor and vulnerable receive the majority of cash transfers, making them the most pro-poor of all spending...

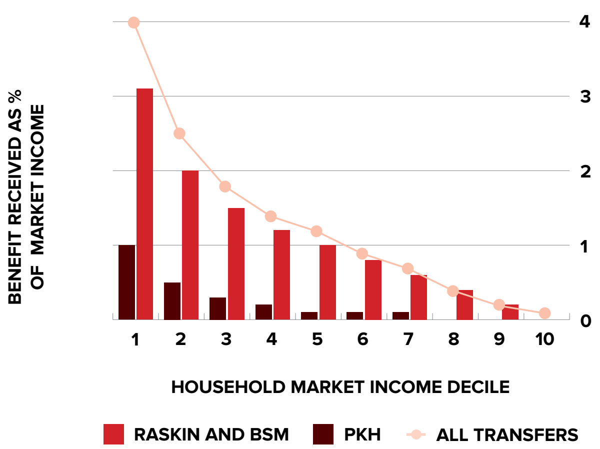
Absolute benefit of cash transfer spending (fig.20)



SOURCE Susenas 2012, APBN 2012 (Realized), World Bank calculations.
NOTE Includes PKH, Raskin and BSM.

...although the benefits are small relative to household income and the most inequality-reducing program (PKH) receives the least funding.

Relative benefit of cash transfer spending (fig.21)



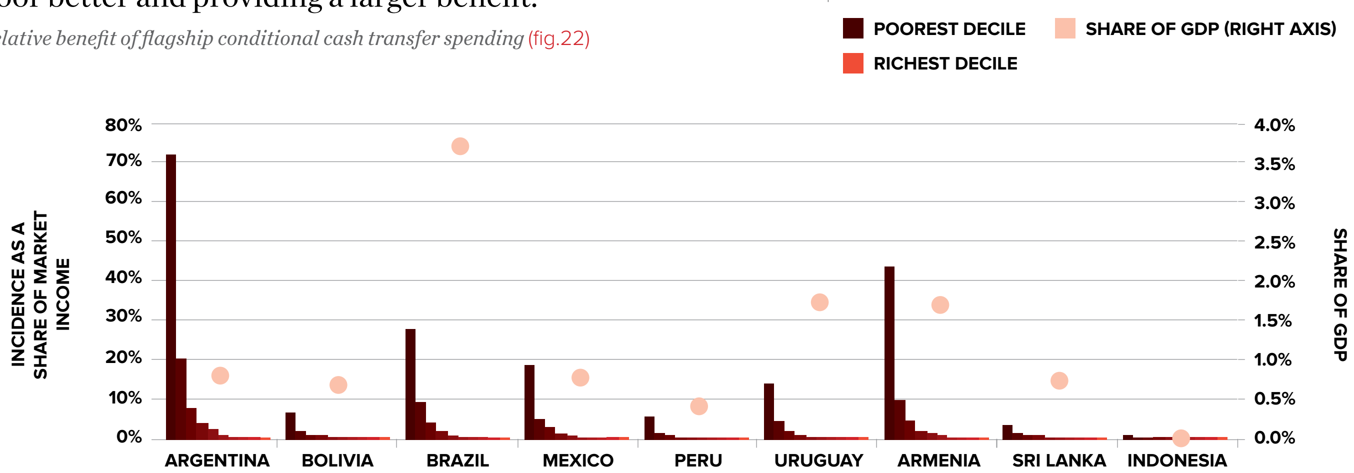
SOURCE Susenas 2012, APBN 2012 (Realized), World Bank calculations.
NOTE Includes PKH, Raskin and BSM.

AS WITH HEALTH AND EDUCATION, OTHER COUNTRIES ACHIEVE FAR MORE INEQUALITY REDUCTION THROUGH CASH TRANSFERS THROUGH MUCH GREATER SCALE AND EVEN MORE PRO-POOR TARGETING. Indonesia's spending on conditional cash transfers (PKH in Indonesia), which is less than 0.1 percent of GDP, is far lower than in the other countries studied, and the value of the average transfer to the poor relative to their income is far less.

Conditional cash transfer spending reduces inequality significantly in a number other countries, by reaching the poor better and providing a larger benefit.

Relative benefit of flagship conditional cash transfer spending (fig.22)

SOURCE For Latin America see: Lustig and Pessino 2014; Paz, *et al.* 2014; Higgins and Pereira 2014; Scott 2014; Jaramillo 2014; Bucheli, *et al.* 2014; Lustig, *et al.* 2014. For Armenia and Sri Lanka, results are preliminary by Younger, *et al.* (2014) and Arunatilake, *et al.* (2014).



Public spending in Indonesia achieves relatively little decrease in inequality because least is spent on those programs that are the most effective

NO SINGLE TYPE OF SPENDING ACHIEVES SIGNIFICANT REDUCTIONS IN INEQUALITY, BUT THE LARGEST IMPACT COMES FROM EDUCATION SPENDING. Total education spending, which is the second-largest spending item after subsidies, reduces the Gini by 1.9 points when moving from market income to final income. This means that it has the largest impact, but this is still relatively small (Figure 23). Taken together, direct transfers, health spending and subsidies reduce the Gini by less than 1 point.

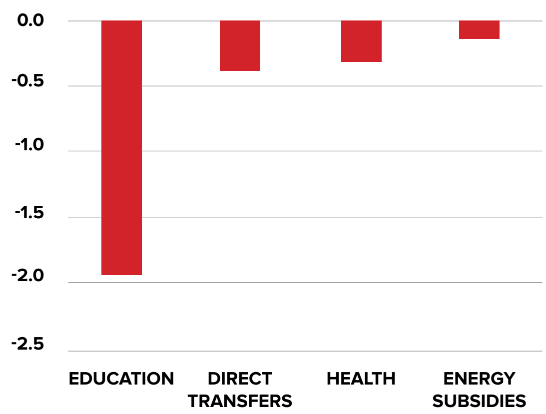
WE CAN CALCULATE THE AMOUNT OF INEQUALITY REDUCED FOR EVERY RUPIAH SPENT: THIS MEASURES WHICH PROGRAMS ARE THE MOST COST-EFFECTIVE AT REDUCING INEQUALITY.
A big program might reduce inequality more than smaller one but spend more to do it. To know which program is the most cost-effective at reducing inequality, which one receives the most "bang-for-the-buck", we need to adjust for the program budget. To do this, we calculate how much inequality is reduced, and divide it by how much is spent on the program to achieve this.

HOWEVER, THE MOST COST-EFFECTIVE INEQUALITY REDUCING PROGRAMS—DIRECT TRANSFERS—HAVE THE LEAST SPENT ON THEM, WHILE ENERGY SUBSIDIES ARE VERY COSTLY AND HAVE LITTLE EFFECT. Direct transfers, such as PKH, Raskin and BSM, are highly effective at reducing inequality for each rupiah spent. However, at 0.33 percent of GDP, very little is spent on them. Education is two-thirds as effective as direct transfers and, because larger sums are spent on it (2.6 percent of GDP), it has the largest overall effect[15]. Health is only one-third as effective in reducing inequality as direct transfers, and also receives relatively little spending (0.9 percent of GDP)[16], so has little overall impact on inequality. Finally, while 3.7 percent of GDP is spent on energy subsidies, they reduce inequality the least in overall terms, meaning they have near zero cost-effectiveness.

EVEN WITHIN DIRECT TRANSFERS, LEAST IS SPENT ON THE MOST EFFECTIVE PROGRAM, PKH. Every rupiah spent on PKH reduces inequality by 2.5 times more than every rupiah spent on Raskin, yet Raskin's budget is more than 10 times higher (Figure 25). Four times more is spent on BSM than PKH, and because of bad targeting[17], BSM is even less effective than Raskin; PKH is over eight times more effective than Raskin at reducing inequality. In education, on the other hand, the most is spent on primary and junior secondary schools, which have the greatest inequality-reducing effect (as poorer households tend to have more children to benefit from this spending than richer households), whereas tertiary spending increases inequality, as very few poorer children make it to university (Figure 26).

Education spending reduces inequality the most, but no type of spending has a significant impact...

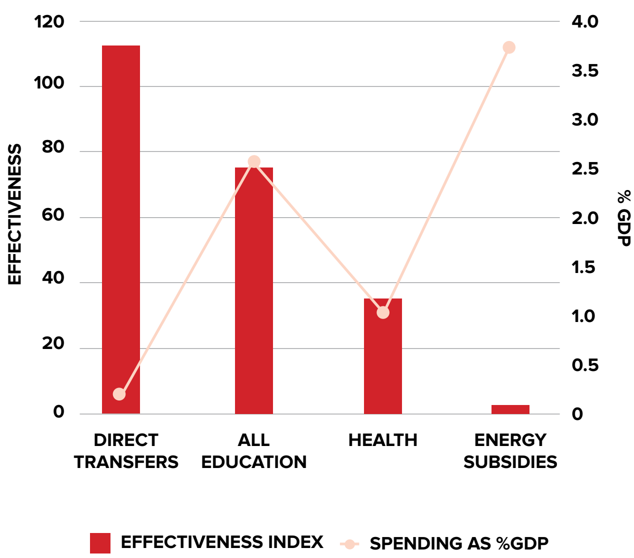
Reduction in Gini coefficient between market and final income (fig.23)



SOURCE Susenas 2012, APBN 2012 (Realized), World Bank calculations.

...because the most cost-effective inequality reducing programs are the smallest.

Cost-effectiveness and total benefits distributed by spending type (fig.24)

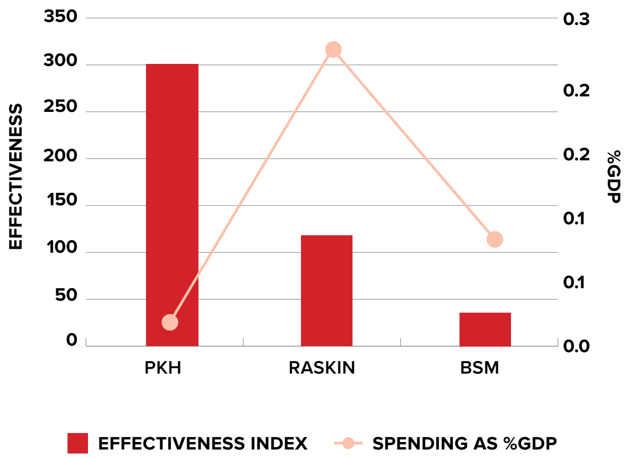


SOURCE Susenas 2012, APBN 2012 (Realized), World Bank calculations.
NOTE Effectiveness is the change in Gini from market income to final income divided by the spending as a percentage of GDP.

15 However, the education received by students may not be perceived as being as valuable as the spending levels. If a teacher is absent, the incidence approach treats the spending on his/her salary as a benefit to the student, although there is none in reality.
16 Although this is being increased significantly in the 2016 budget.
17 Historically BSM was targeted by school committees and many scholarships went to non-poor children. However, since 2012, BSM (now KIP) has been targeted with the new Unified Database (UDB) of the poor and vulnerable, implemented by TNP2K (the National Team for the Acceleration of Poverty Reduction), and targeting outcomes for BSM have improved significantly.

Of the direct transfers, the least is spent on the most cost-effective program, PKH...

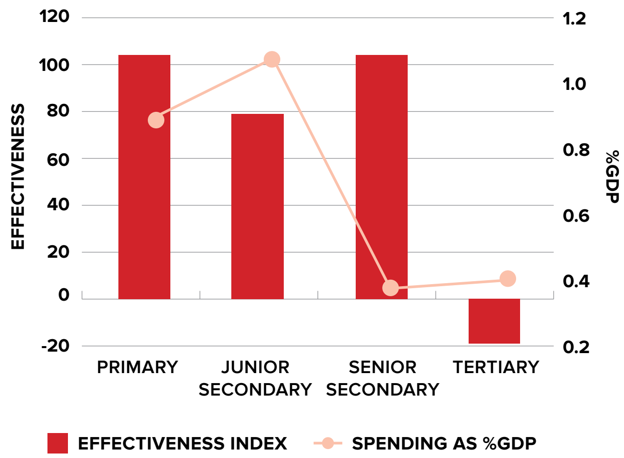
Cost-effectiveness and total benefits distributed by spending type (fig.25)



SOURCE Susenas 2012, APBN 2012 (Realized), World Bank calculations.
NOTE Effectiveness is the change in Gini from market income to final income divided by the spending as a percentage of GDP.

...because the most cost-effective inequality-reducing programs are the smallest.

Cost-effectiveness and total benefits distributed by spending type (fig.26)



SOURCE Susenas 2012, APBN 2012 (Realized), World Bank calculations.
NOTE Effectiveness is the change in Gini from market income to final income divided by the spending as a percentage of GDP.

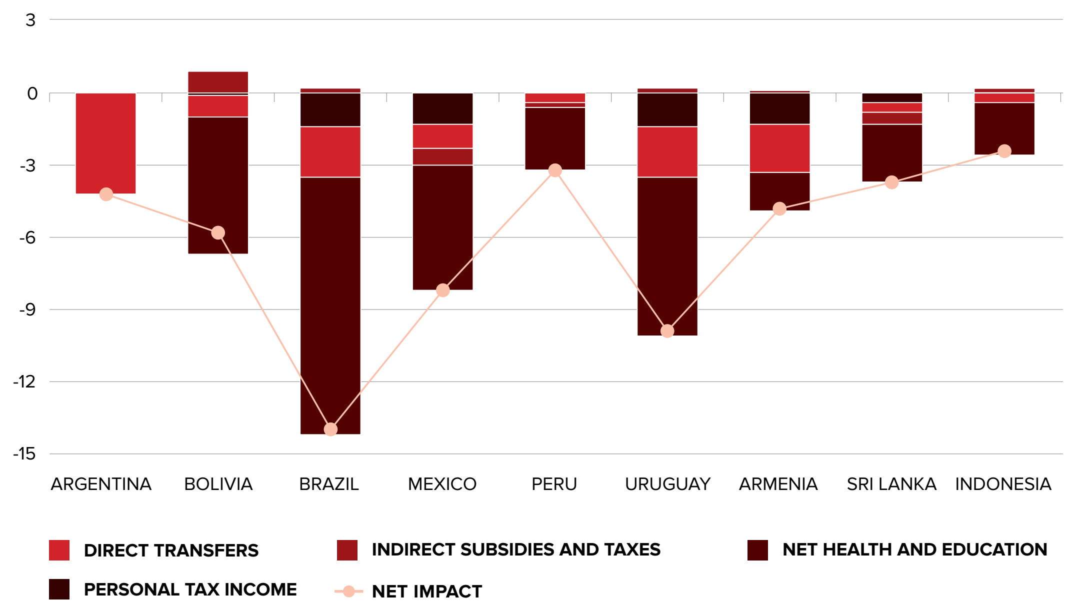
4. HOW THE GOVERNMENT CHOOSES TO RAISE MONEY CAN AFFECT INEQUALITY

While the greatest impact on inequality is likely to come through how the Government chooses to spend money, how it raises money matters too

SPENDING CHOICES ARE MORE LIKELY TO REDUCE INEQUALITY THAN TAXES. Although personal income taxes help to reduce inequality in a number of countries, a greater impact comes from direct cash transfers, and from net education and health spending most of all (Figure 27). Only in Mexico does the inequality reduction from personal income taxes exceed that of cash transfers, and even then it is much less than that from health and education. The net effect of indirect subsidies and indirect taxes can increase or decrease inequality, but usually has relatively little combined effect.

Taxes can reduce inequality, but not usually as much as spending on education, health and direct cash transfers.

Change in Gini from different fiscal policies (fig.27)



SOURCE For Latin America see: Lustig and Pessino 2014; Paz, *et al.* 2014; Higgins and Pereira 2014; Scott 2014; Jaramillo 2014; Bucheli, *et al.* 2014; Lustig, *et al.* 2014. For Armenia and Sri Lanka, results are preliminary by Younger, *et al.* (2014) and Arunatilake, *et al.* (2014).

NOTE Only direct transfer effect is available for Argentina. Indonesia excludes personal income tax effect, although this is likely to be small.

HOWEVER, WHILE FISCAL POLICY AND PUBLIC SPENDING CAN BE USED TO ADDRESS INEQUALITY, IT MUST BE DONE IN A SUSTAINABLE FASHION. Many Latin American countries have significantly reduced inequality through fiscal policies.Progressive taxing and spending that primarily benefit the poor and vulnerable are important tools for tackling inequality. However, they must be used in sustainable ways. When too much is spent on redistribution and other social spending, relative to revenues, the fiscal framework can become unsustainable. In Brazil, for example, cash transfers now represent 4 percent of GDP. In addition, when social transfers are too large, it can create a disincentive to work (cash transfers are worth 70 percent of market income to the poorest decile in Argentina (Lustig and Pessino 2014)).

HOW PUBLIC REVENUE IS RAISED WILL ALSO AFFECT INEQUALITY. Three-quarters of Indonesia's public revenues come from taxes (Table 2). Different taxes can be used to collect revenue. The amounts of revenue that can be raised, and the ease of implementation, differ. At the same time, different taxes and excises are borne by different types of household. The main taxes we examine for Indonesia are value-added tax (VAT) and the tobacco excise, which together make up nearly half of all tax revenue (Figure 28).

We look at tax revenues, which make up three-quarters of all revenues.

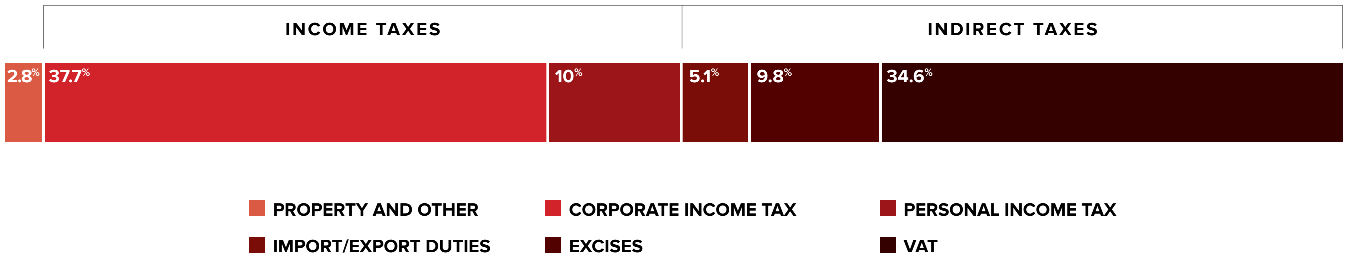
2012 APBN (Realized) revenue (tab.2)

APBN 2012 (Realized)	IDR trillion	% GDP	% Revenue
1. Tax revenues	981	11.9	73.3
2. Non-tax revenues	352	4.3	26.3
3. Grants	6	0.1	0.5
Total revenue	**1,338**	**16.2**	**100**

SOURCE Ministry of Finance

VAT is the most important tax, followed by personal income tax and excises. Corporate income tax is excluded from the analysis.

2012 tax revenue by type (fig.28)



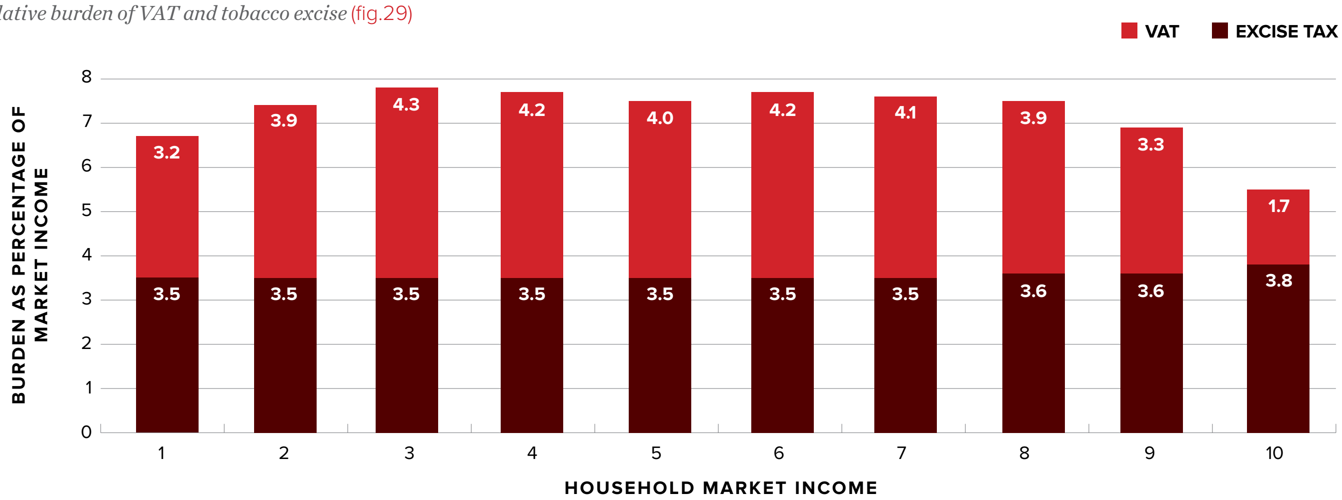
Indirect taxes in Indonesia do not have much impact on inequality. Closing VAT exemptions on basic staples would increase revenue but also inequality; increases in tobacco excise would be more effective

VALUE-ADDED TAX AND THE TOBACCO EXCISE ARE IMPORTANT SOURCES OF REVENUE IN INDONESIA THAT NEITHER INCREASE NOR DECREASE INEQUALITY IN INDONESIA. Over one-third of Indonesia's tax revenue comes from direct taxes, mainly VAT. VAT is almost completely neutral, with richer households paying about the same percentage of their market income in VAT as poorer households (Figure 29). The tobacco excise is slightly regressive but does not significantly affect inequality, reducing the Gini by only 0.4 points. Moreover, even if a tobacco tax is regressive, there is evidence that the poor save more in the long run from reduced health expenditures in the future, as well as being more likely to benefit from a reduction in premature lives than the rich (Savedoff and Alwang 2015).

VAT is almost completely neutral, with poorer and richer households paying the same as a percentage of their market income. The richest households pay less in tobacco excises than the rest of the population, the effect on the Gini is very small.

SOURCE Susenas 2012, APBN 2012 (Realized), World Bank calculations

Relative burden of VAT and tobacco excise (fig.29)

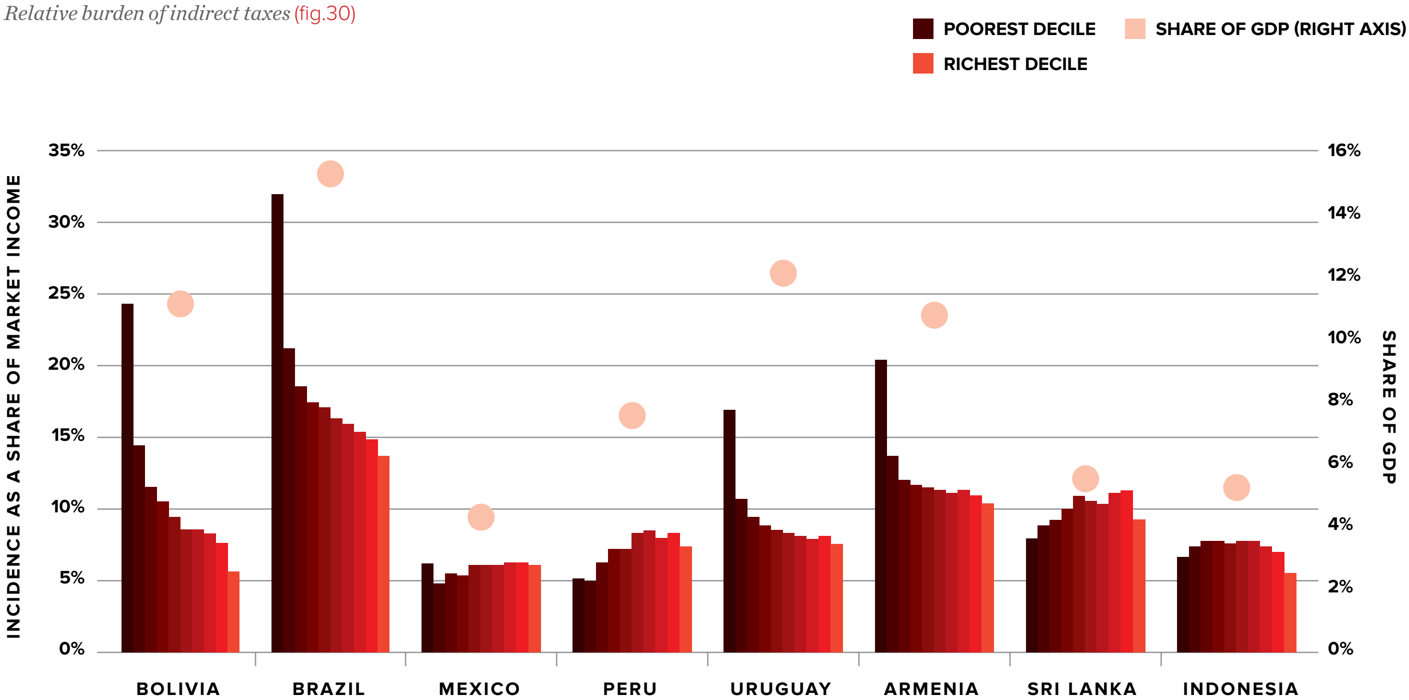


IN SOME OTHER COUNTRIES, INDIRECT TAXES RAISE MORE MONEY, BUT ARE ALSO FELT MORE BY THE POOR. As Figure 30 shows, indirect taxes are either neutral or favor the poor in Mexico, Peru, Sri Lanka and Indonesia, but are borne heavily by the poor in Bolivia, Brazil, Uruguay and Armenia. In the more neutral countries, indirect taxes bring in less revenue as a share of GDP, while in the regressive countries they bring in considerably more revenue. This is likely because the greater revenue with increases in inequality come through fewer or no exemptions on staple items, which are consumed frequently by poorer households.

In countries that raise more revenue through indirect taxes, those taxes are borne more by poorer households. In countries with more neutral indirect taxes, less revenue is raised.

Relative burden of indirect taxes (fig.30)

SOURCE For Latin America see: Lustig and Pessino 2014; Paz, *et al.* 2014; Higgins and Pereira 2014; Scott 2014; Jaramillo 2014, Bucheli, *et al.* 2014; Lustig, *et al.* 2014. For Armenia and Sri Lanka, results are preliminary by Younger, *et al.* (2014) and Arunatilake,*et al.* (2014).

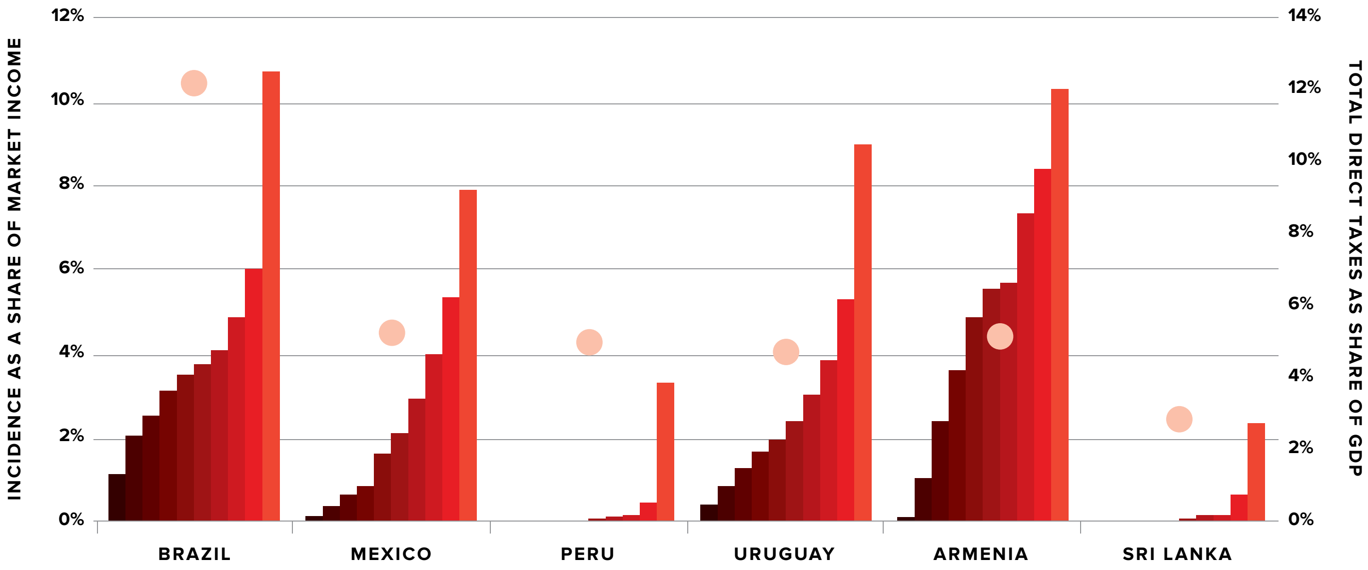


Revenue from personal income tax is low in Indonesia; increased compliance and a broader tax base would increase revenue and lower inequality

A BROADER PERSONAL INCOME TAX CAN BOTH RAISE SIGNIFICANT REVENUE AND REDUCE INEQUALITY. Personal income taxes make up only 10 percent of tax revenues in Indonesia, or around 1.9 percent of GDP. In other countries, they raise significantly more revenue and this is borne to a much greater degree by the rich, helping to reduce inequality (Figure 31)[18].

A number of other countries have used personal income taxes to both raise significant revenue and reduce inequality, with the richest households paying significantly more as a percentage of their market income.

Relative burden of personal income taxes (fig.31)



SOURCE For Latin America see: Lustig and Pessino 2014; Paz, *et al.* 2014; Higgins and Pereira 2014; Scott 2014; Jaramillo 2014, Bucheli, *et al.* 2014; Lustig, *et al.* 2014. For Armenia and Sri Lanka, results are preliminary by Younger, *et al.* (2014) and Arunatilake,*et al.* (2014).

[18] Indonesia's personal income taxes were not included in this study as they are not captured in the household survey, and many of the high income earners who would be among the few who do pay income tax are not in the survey data either.

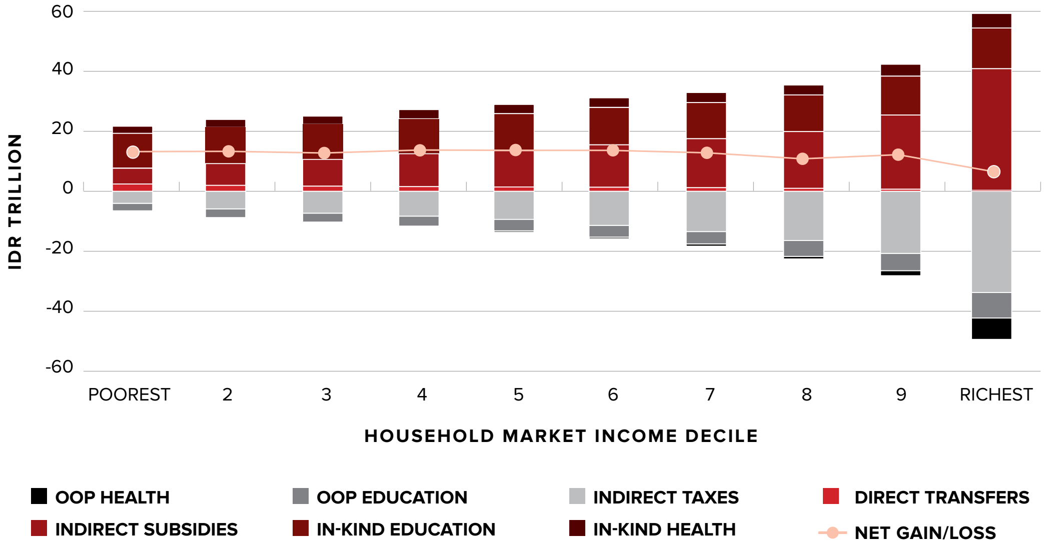
5. CONCLUSION

Excluding income taxes, all households are net beneficiaries of Indonesian taxes and spending. Poorer households enjoy net benefits as a greater percentage of market income, but in total they represent only a 25 percent increase in spending power.

RICHER HOUSEHOLDS RECEIVE MORE GOVERNMENT SPENDING BUT PAY MORE IN TAXES AND OUT-OF-POCKET EXPENSES, MEANING MOST HOUSEHOLDS RECEIVE ABOUT THE SAME NET SPENDING. The poorest 10 percent of households receive IDR 21 trillion of total transfer, subsidy and social spending, compared with IDR 59 trillion for the richest 10 percent (Figure 32).However, the poorest households pay only IDR 7 trillion in indirect taxes and out-of-pocket health and education expenses, and the richest households pay IDR 49 trillion. The richer a household is, the more it receives in benefits but the more it pays in taxes and expenses. As a consequence, most households receive the same benefits from government spending after taxes, or around 9-11 percent of the total. Only the richest households receive slightly less, at 7 percent, and even then, they remain beneficiaries of net spending (although personal income taxes have not yet been factored in).

Most households receive the same benefits from government spending after taxes and expenses; richer households benefit more from spending, but pay more in taxes and expenses than poorer households.

Absolute benefits and burdens of taxes and spending in Indonesia (fig.32)



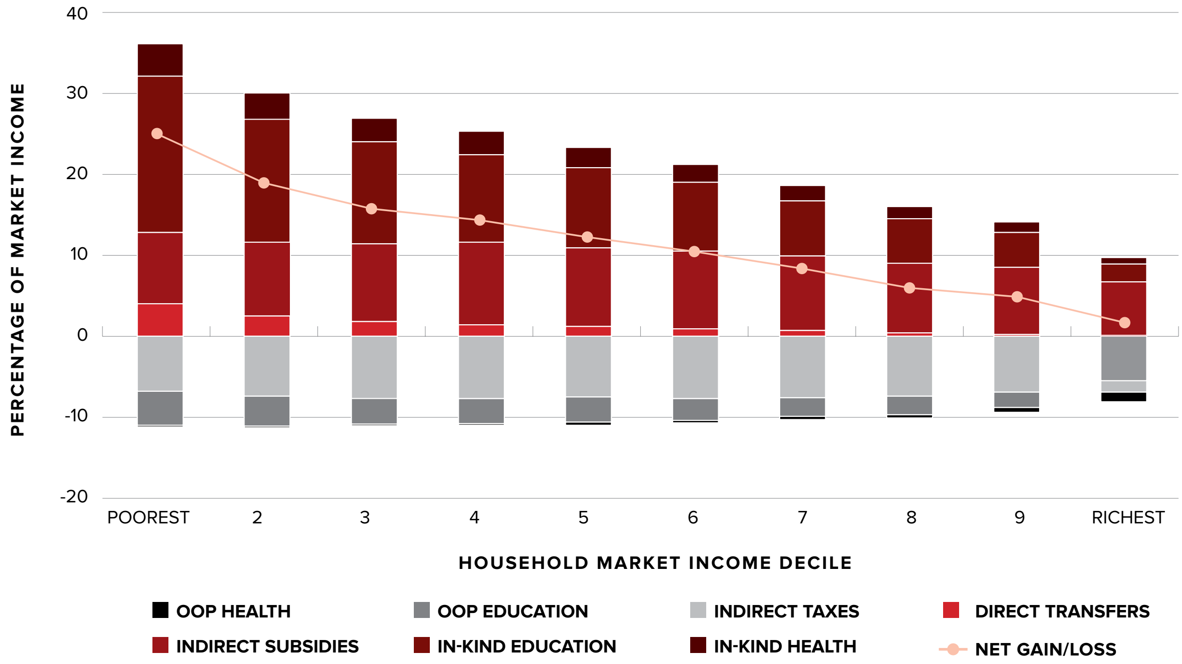
SOURCE Susenas 2012, APBN 2012 (Realized), World Bank calculations

HOWEVER, GOVERNMENT SPENDING BENEFITS POORER HOUSEHOLDS MORE RELATIVE TO THEIR MARKET INCOME. NONETHELESS, THE NET BENEFIT TO THE POOREST HOUSEHOLDS IS ONLY 25 PERCENT OF THEIR INCOME. Although the benefit of net government spending (after taxes and expenses) is similar for all households, because poorer households have such low incomes it represents much more to them as a percentage of market income than it does for richer households (Figure 33). However, as we have discussed earlier, subsidies benefit all households to a similar proportion of market income, and education is not as pro-poor as it is in other countries. With these representing the two largest spending items, and the spending that does benefit the poor the most, direct transfers, the least, then total benefit of net spending for the poorest 10 percent of households is worth only 25 percent of their market income. This is no doubt a welcome boost, but does not substantially change their welfare, and is too little to have a significant impact on poverty or inequality.

Net government spending represents a greater share of their market income for poorer households than richer ones. However, even for the poorest 10 percent, it boosts incomes by only one-quarter.

Relative benefits and burdens of taxes and spending in Indonesia (fig.33)

SOURCE Susenas 2012, APBN 2012 (Realized), World Bank calculations



The taxes and spending examined so far only result in a small reduction in inequality in Indonesia

THIS PAPER CONSIDERS THE IMPACT OF VARIOUS GOVERNMENT TAXES AND SPENDING ON INEQUALITY. On the revenue collection side, we have focused on VAT and excise taxes. On the expenditure side, we have analyzed the distribution of benefits from 57 percent of primary government spending with a focus on social spending, including direct cash transfers and health and education spending, and non-social fuel subsidy spending.

THE OVERALL RESULT IS THAT INDONESIA'S 2012-ERA FISCAL POLICY REDUCED INEQUALITY SLIGHTLY THROUGH A NEUTRAL INDIRECT TAX SYSTEM AND SLIGHTLY PROGRESSIVE SOCIAL SPENDING. In other words, everyone in Indonesia contributes tax revenues (through their consumption activities) while the Government uses these resources (and others) to provide transfers and in-kind spending that raises incomes for the poorest individuals and households. However, there are *very few* representative individuals who pay more in taxes than they receive in transfers, meaning that the fiscal system provides a boost to income (on average) at all points along the income distribution. As a result of the fiscal system, the Gini coefficient was reduced by 2.5 points, only a modest reduction.

TAXES FROM HOUSEHOLDS ARE MAINLY RAISED THROUGH CONSUMPTION, RATHER THAN DIRECTLY ON INCOME. These consumption taxes are neutral to slightly regressive. Personal income taxes are likely highly progressive but are a smaller component of government income and are not paid by most households in the survey data.

THE COMBINATION OF SOCIAL SPENDING AND ENERGY SUBSIDIES REDUCES INEQUALITY SLIGHTLY, AND MOSTLY THROUGH IN-KIND BENEFITS OF EDUCATION. Direct transfers are the most cost-effective way of reaching the poor and vulnerable and reducing inequality, but relatively little is spent on them. Energy subsidies and education spending alone account for about 80 percent of all public spending examined here. Energy subsidies in 2012 were very slightly progressive and large enough in magnitude to roughly cancel out the indirect tax burdens created by Indonesia's VAT and excise tax regimes. As a consequence, the resulting "net subsidy" on consumption activity is neutral to slightly progressive. Direct transfers more effectively target the poor than in-kind transfers or subsidies. However, they are also quite small in size—

total spending on all direct transfers represents is less than 0.5 percent of GDP—and either provide relatively small benefit packages or do not have very broad coverage. As a result, the inequality and poverty reduction impacts of these transfers are limited. In-kind benefits, which are generally larger in terms of transfer size than are direct transfer, are received only upon access, and poorer households in Indonesia have far lower rates of secondary- and tertiary-level education access than do rich households, which limits the progressiveness of these sizeable transfer programs.

WHILE FISCAL POLICY DOES ACHIEVE A LIMITED DEGREE OF REDISTRIBUTION IN INDONESIA, IT IS LESS THAN IS ACHIEVED IN MOST OTHER COUNTRIES STUDIED, OFTEN BY A NUMBER OF TIMES. The modest impacts of fiscal policy result from low direct income tax collection and low social spending levels, as well as the fact that untargeted energy subsidies and education expenditures—both of which are roughly neutral in distribution and not pro-poor—are the largest budget items. Compared with the rest of the CEQ country set, Indonesia begins with a relatively low market income Gini. But other countries with similarly low market income Ginis—Armenia or Ethiopia—do better than Indonesia in terms of inequality reduction through fiscal policy (while spending similarly low amounts). Regardless of the ideal size of fiscal spending in Indonesia, policymakers could further enhance income equality and reduce the number of impoverished citizens by shifting fiscal priorities.

Further research is needed to bring in other key components of fiscal policy

THIS PAPER USES 2012 DATA, THE LATEST AVAILABLE DATA AT THE TIME. Since then, a number of new and important developments have taken place. First, fixed fuel prices were increased in 2013, and accompanied by an expansion in the BSM scholarships program and the distribution of temporary cash assistance in the form of BLSM (*Bantuan Langsung Sementara Miskin*). At the end of 2014, fuel prices were raised again and a further round of BLSM issued. At the beginning of 2015, fuel subsidies were removed for gasoline and lowered for diesel, and further expansions made for BSM and PKH.

FURTHERMORE, A NUMBER OF KEY FISCAL POLICIES HAVE BEEN EXCLUDED FROM THE CURRENT ANALYSIS: PERSONAL INCOME TAXES AND INFRASTRUCTURE. Personal income tax (PIT) is missing because most (wealthier) PIT payers are not covered in the survey data. Moreover, the absence of these wealthier households will also distort the 2012 results presented here. This is because these households are likely to pay higher VAT, as well as PIT, and potentially benefit more from certain types of spending (such as fuel subsidies) but less from others (such as education if they are sending their children to private schools). That means that the richest decile of households may no longer still be net recipients of fiscal taxes and spending. Finally, infrastructure spending has been excluded because of the methodological difficulties in allocating the benefits of such spending across households.

TO ADDRESS BOTH THESE RECENT DEVELOPMENTS AND MISSING ANALYZES, THE FISCAL POLICY AGENCY AND WORLD BANK HAVE AGREED A JOINT WORK PROGRAM THAT WILL:

1. Extend the analysis to the 2013 budget, capturing the effects of the fuel subsidy reforms and temporary cash compensation;
2. Extend the analysis to the 2015 budget, capturing the removal of fuel subsidies, temporary cash assistance and expansion of BSM and PKH;
3. Extend the analysis to capture both higher income earners and personal income taxes by building upon the top incomes methodology and data of Wai-Poi, *et al.* (forthcoming); and
4. Pilot new methodological approaches to capturing the incidence of infrastructure spending.

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