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Indonesia in Transition: Impediments to Fuel Subsidy Reform

By Keoni Indrabayu Marzuki

Synopsis

President-elect Joko 'Jokowi' Widodo is bracing himself to face policy challenges left behind by his predecessor, chief of which is the fuel subsidy issue. What impedes the reallocation of fuel subsidy funds and what are the possible solutions?

Commentary

DESPITE HAVING won the President and Vice-President posts respectively, Joko Widodo and Jusuf Kalla will possess little control, if at all, on the formulation of the next state budget for fiscal year 2015/2016. One particular issue that concerns the new administration is the large portion of funds for energy subsidies, particularly fuel subsidies.

To ensure his administration would have more fiscal space to fund new government projects and minimise the budget deficit, President-elect Jokowi, as he is usually called, has proposed to outgoing President Yudhoyono to increase the price of subsidised fuel as his final policy gesture before stepping down. President Yudhoyono turned down the request on the ground that increasing the price of subsidised fuel would aggravate the economic burden of the people.

Key step to fuel subsidy reform

The amendment to the fuel subsidy budget would be an important step towards fuel subsidy reform. The government allocated 300 trillion Rupiah (about US\$25 billion) on energy subsidies in 2014. Around 80 per cent of the energy subsidy fund, or about 250 trillion Rupiah, is spent on fuel subsidies alone. In the proposed 2015/2016 budget, President Yudhoyono allocated 290 trillion Rupiah for fuel subsidies.

The new budget also portends a relatively larger deficit ratio of 2.32 percent to GDP. Indonesia's Finance Minister Chatib Basri estimated that by increasing the price of fuel and thereby reducing the subsidies, the government could reduce the deficit ratio to 1.32 per cent.

External influence such as the cessation of quantitative easing by the US Federal Reserve may negatively affect the Rupiah in the coming months. The weakening of the currency would mean that

the new administration would have to spend more to procure oil from the international market. Consequently, fuel subsidies would impose a severe burden on the budget.

Why fuel subsidy scheme must be reformed

The persistence of the annual fuel subsidy policy is a predicament for the government. There has been strong advocacy to reform the fuel subsidy scheme to eliminate or alleviate its negative consequences on the budget. There are other pressing concerns as well.

First and foremost, fuel subsidies are ineffective. It was initially intended to grant the access of affordable energy supplies to the poor. However, as the economy progressed, fuel subsidies benefitted the middle and upper classes instead. The Ministry of Energy and Mineral Resources estimated that around 70 per cent of subsidised fuel is consumed by the middle and upper classes.

Fuel subsidy also impairs the country of much needed infrastructure development. As fuel subsidies takes about 20 percent of the state budget, it constrains the remaining fiscal allocation for infrastructure development. Consequently, Indonesia still suffers from basic infrastructure deficiencies in numerous public sectors namely clean water, sanitation, health, public transportation, communication, education and electricity despite the booming economic growth in recent years.

Ultimately, fuel subsidies undermine Indonesia's energy security by encouraging extravagant demand as fuel price is relatively low. With Indonesia's oil production output stagnating, the government would have to import more oil. Dependence on foreign sources renders Indonesia's energy security vulnerable to supply disruptions and rapid price fluctuations.

In addition, heavily subsidised fuel consumption also undermines Indonesia's effort to diversify its energy intake, as demand for cheaper fuel will undermine demand for other forms of available energy. Furthermore, excessive consumption also leads to a supply crisis as it propels fuel consumption far beyond the allotted quota.

Finding the delicate balance

The path to reallocate fuel subsidy funds is arduous and faces many impediments, especially politically. Firstly, Jokowi would have to convince the opposition to pass the proposed revision to the budget which had been approved by parliament in September. The government coalition would have to secure an additional 20 percent of parliamentary votes to acquire a simple majority. Golkar and the Democrat Party (PD) would be ideal allies. However, political development in Golkar and PDIP's rivalry with PD may have closed this opportunity in the short-term.

The infancy of the new administration would also be a challenge. Considering that the Jokowi administration would only be in its first months in power, putting forward such a bold programme so early may invite a severe public backlash. This would be directed at the PDIP as it has always rejected President Yudhoyono's policy to increase the price of fuel subsidies. Such a flip-flop will weaken PDIP's popularity in the future.

Ultimately, time is not on Jokowi's side. The primary concern is how to cushion the poor and the needy from the negative implications of expected price hikes. The new administration would have to introduce temporary economic measures to minimise such impacts. Finding a solution within a tight deadline may lead the administration into a blind spot.

Historically, no president has ever planned to increase the price of subsidised fuel so early after inauguration. There are a series of steps to enact fuel subsidy reform, but considering the challenges Jokowi faces, it is of utmost importance to develop a plan to cushion the poor and the needy from the adverse economic effects.

Similarly direct cash assistance schemes may be a viable short-term option in favour of the poor and needy. Taking its cue from the Yudhoyono administration, even though the scheme may be precise, such a policy lacks the ability to tackle the fundamental problem of economic empowerment as the poor and needy will face the same economic hardship after the cash assistance programme ends.

The ultimate solution is to redirect the fuel subsidy fund into infrastructure development to encourage job creation, thus increasing the purchasing power of the poor. Unfortunately, such a programme would take too long to materialise. The new administration would have to find a balance between short and long term measures to alleviate potential negative consequences. Most importantly, the public needs to be assured that the fuel price hike does not mean that fuel subsidy funds are being reduced, but rather reallocated into other sectors essential for the people's social welfare.

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